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OHIO AGRICULTURAL DEBTOR/CREDITOR LEGAL HANDBOOK

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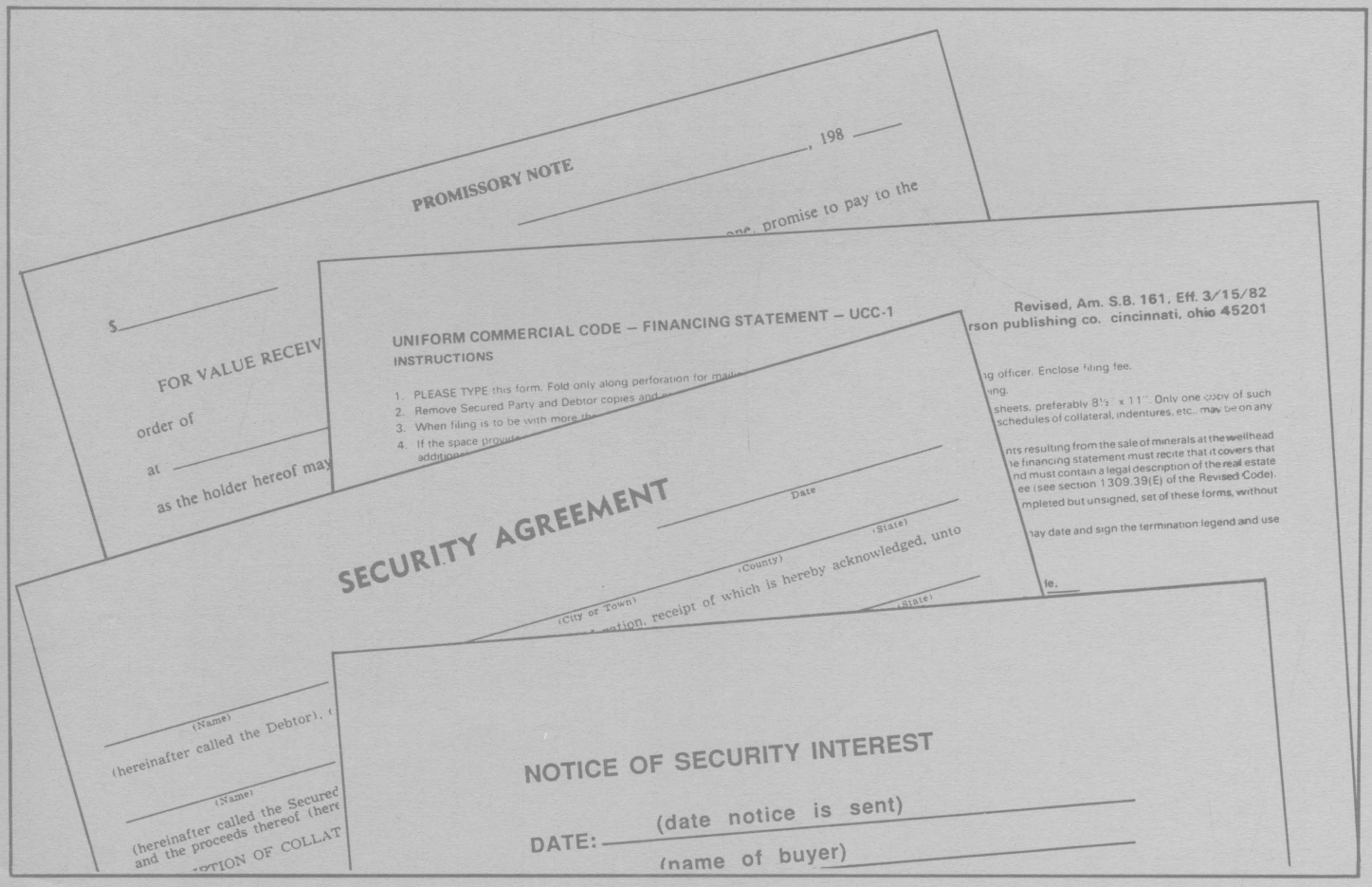
OHIO AG LAW



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THERE ARE SEVERAL IMPORTANT CAUTIONS FOR USERS OF THE HANDBOOK. THIS IS NOT AN OFFICIAL INTERPRETATION OF ANY REGULATION OR LAW. THIS SUMMARY DOES NOT HAVE THE WEIGHT OF LAW. THIS HANDBOOK SHOULD BE REGARDED AS AN EDUCATIONAL PRESENTATION OF AGRICULTURAL DEBTOR/CREDITOR LAW, FINAL INTERPETATION OF ANY LAW SHOULD BE MADE WITH LEGAL AND TAX COUNSEL.

The Chapter on Creditor Collection Rights was researched and written in cooperation with Loraine M. Haase, a graduate student in the College of Agriculture at The Ohio State University.

A special thanks to Beth Tabriz, Cindy Dishon, and Debbie Turnbull for typing, proofreading, numerous drafts and the final copy, and coordination of the printing of this handbook.

The Authors

LEGAL CONSIDERATIONS OF FARM DEBTORS AND CREDITORS

Times of financial stress tend to focus and magnify financial legal concerns. In the farm sector the decade of the 80's has been a time of severe financial stress and several legal issues have been brought into focus. However, at any time there are individuals, families, and businesses who are experiencing financial difficulties even though an entire industry may not be undergoing a major financial adjustment.

Whenever money is borrowed thought should be given to the legal ramifications. These legal ramifications create rights and responsibilities on the part of both debtors and creditors. The list of legal considerations is long but not everyone experiencing financial difficulties encounters the same legal concerns.

One of the first legal realizations is that not all creditors are alike. Some creditors may have an oral promise for payment and other creditors may have a simple written promissory note, but the most prudent lenders have enforceable security interests against named assets. These differences among creditors determine essentially which ones gets paid first if a business becomes financially unstable.

A debtor with limited funds must understand the agreements that have been made with creditors and follow the terms of those agreements as payments are scheduled. The four principle financial contracts that are used and need to be understood by both debtors and creditors are promissory notes, security agreements, financing statements and real estate mortgages.

Of course, as with any agreement the terms may be altered if the involved parties agree. Some of the possibilities are: (1) a creditor or creditors may subordinate their interest in security to another creditor to enable financial management by the debtor; (2) one creditor releasing entirely an interest in certain security; (3) altering the payment schedule; (4) reducing the interest rate; and (5) a creditor may even write off a portion of a loan. To negotiate any alternations in loan agreements, a debtor needs to fully understand his/her credit position and present feasible financial management plans to creditors. A meeting with all creditors may help to accomplish alterations in agreements.

When money is borrowed for farm purposes today, the creditor will frequently ask to whom the farmer intends to sell the farm products. The creditor will then send a notice to those potential buyers, often asking for a joint check to be issued when the products are purchased.

In 1983, Ohio passed a law providing the opportunity for creditors to put buyers of farm products on notice of security interests. As a part of the 1985 Farm Bill the various state laws relating to buyers of farm products were preempted and the Federal law now controls. The purpose of this law is to cope with the problem of buyers of farm products having to pay twice, once to the debtor and again to the secured creditor if the debt goes unpaid after payment was made for the farm products.

If no notice is received by the buyer or if the buyer follows the instructions on the notice, there is no buyer responsibility for the unpaid debts. Farm borrowers can expect to continue to be asked for a list of potential buyers of farm products as loan arrangements are made and they must comply.

Creditors often ask for cosigners on notes before loans will be granted. In order to help a relative or a friend get started or continue in business, some people have agreed to cosign a note. Creditors have at times had to enforce collection against the cosigners.

Any cosigner needs to fully understand his/her legal rights and responsibilities. There are different cosigner agreements; a comaker, a guarantor and a surety. Each of these carry different responsibilities for both the cosigner and for the creditor. It is recommended that a thorough discussion of the rights and responsibilities of cosigning be held by the parties before signing the agreements.

Another legal concern which has surprised some farmers is the resulting tax consequences as assets are liquidated in order to pay debts. Either complete or partial farm liquidations can bring about this problem. This concern relates to selling assets, to transferring assets to a creditor in lieu of foreclosure, and to debt forgiveness. Before major liquidations are made a tax consultant should be contacted to review the liquidation plans.

A checklist of potential taxes includes: ordinary income, capital gains income, the alternative minimum tax, discharge of indebtedness income, recapture of depreciation, recapture of past tax deductions like conservation expenses, recapture of investment tax credit, recapture of special use valuation tax savings from a past estate or acceleration of estate tax installment payments arranged in a past estate.

Another important part of the legal ramifications are a creditor's enforcement rights if a default on a loan has occurred. The normal default identified is the failure to make a payment on a loan when it is due. For those creditors who have security agreements in place with a debtor, there may be

other events identified as causing default such as not adequately maintaining the collateral, failing to pay property taxes, or failing to carry insurance on security. A creditor's rights in case of default extend from self-help repossession of the identified security to obtaining a court judgment and following through on foreclosure proceedings. A debtor facing creditor collection after default has occurred should be aware of creditor's rights.

Bankruptcy has an extended list of legal rules to be understood. Sometimes the most appropriate step for a debtor to take is to file bankruptcy. There are four different types of bankruptcy being used by farmers: Chapter 7--which leads to liquidation of the debtor's assets, Chapter 11--which has the purpose of reorganizing and restructuring the debt obligations and the business to enable a work out of the financial difficulties, Chapter 12--which was enacted in late 1986 specifically to help farmers restructure loans and continue in business, and Chapter 13--which has the purpose of enabling wage earners and self-employed persons with limited debt to reorganize to work out of the financial difficulties. Some important concepts of bankruptcy are: the automatic stay placed against creditors, creditor rights within bankruptcy, exempt property, fraudulent transfers, preferential transfers, priorities for payments, abandonment of assets, plans to be submitted to court, and discharge.

Some debtors have felt their rights have been violated by creditors and as a result there have been several lawsuits against creditors. Issues which debtors have raised in cases against their creditors include: (1) the creditor is fiduciarily responsible, ie. has taken control of the business to such an extent that he is responsible for and should assume the losses; (2) the creditor made promises, oral or written, which were not followed; (3) the creditor has not followed it's customary practices; (4) the creditor has not dealt in good faith; (5) the creditor has not followed specific statutory laws; (6) the creditor used duress; (7) the creditor used fraudulent practices; and (8) the creditor was negligent in practices after becoming fiduciarily responsible for the debtor's business. This is a developing area of debtor/creditor law and any case will have difficult and time consuming court proceedings.

A great aid to working through financial difficulties is communication. Lack of communication only multiplies the legal ramifications. Communication among debtors, creditors, attorneys, accountants and financial consultants should allow management to occur within agreed to and negotiated terms and should try to minimize uncertainties.

There is a saying among bankers that, "bad loans are never made but that some good loans go bad." The counter is, "that a borrower never intends to encounter financial difficulties." However, if financial difficulties happen it is best to know the promises one has made. The lesson for all is that there should be a full understanding of loan agreements and a practical knowledge of debtor/creditor law before loan commitments are made.

OBTAINING PROFESSIONAL COUNSEL

There are several counselors who should be contacted if financial difficulties are encountered. Most debtors would prefer to avoid the expenses of obtaining help from professional counselors, however experience indicates that these people are needed and the earlier contacts are made the more options there are for financial stress management. There is expertise available to farmers in the technical areas of law, tax, farm business management, and psychological adjustment. Many of these professionals have been studying, attending seminars, and gaining experience on topics related to the farm financial crisis.

Farmers should expect these counselors to have knowledge about the practices and policies of farm creditors, alternatives that may be available for farm financial management, experience in farm bankruptcy, an understanding of the tax implications, an awareness of the unique characteristics of farm businesses, and personal stress management tactics. A counselor who is selected should be in a location that is accessible to his client and near local or regional courts or other authorities.

There should be more than one counselor involved as alternatives are evaluated and pursued. These counselors should be regarded as a team working for the farmer. The team could consist of an attorney, an accountant, and a farm management specialist. Team members need to discuss the situation and be in agreement on any alternatives that might be pursued. The farmer should be certain that the team is working together.

TEAM MEMBERS

Finding the necessary team members has been a challenge for many farmers. Farmers have not been accustomed to seeking this type of help in farm financial planning and management. The selection of team members is an important process that should not be done hastily. References should be sought from neighbors and friends, other counselors, farm organizations, the Ohio Cooperative Extension Service, and personnel from other business contacts.

After a referral list has been compiled, appointments should be made with selected counselors. During that appointment the conversation should focus on the farm business and family situation. Be willing to share facts with the counselors; ask questions of them, some of which may be of a technical nature; listen to the answers; evaluate the recommendations given; and discuss fees and how these might be paid.

Sometimes one may not be happy with the first person contacted. Personality conflicts, lack of experience,

lack of understanding of a particular farm situation, or other factors may cause one to get a second opinion. Plan to invest some time in the selection of the counselors. The team members are very important to a successful emergence from the financial difficulties you, your family, and your farm business are facing.

Once the team members have been selected and appointments are made, there is the question of who should attend the appointments, especially the initial meetings. Definite consideration ought to be given to the following people attending: the farmer, his/her spouse, children involved in the business, and other business partners. All of these people need to know the situation and have input concerning the alternatives being considered.

Each counselor has specific knowledge and skills and should be expected to provide specific services. The Ohio Cooperative Extension Service faculty and other farm management consultants can provide technical production information, that is, information related to production practices and alternative production practices. These people have available facts and projections for budgeting various farm enterprises. The Extension faculty also have several computer programs that can assist in analyzing the current farm situation and projecting future alternatives for the business. Farm management counselors can provide essential information for the financial planning process.

Accountants have been trained in tax, record keeping, and budgeting. This kind of expertise will be needed, especially in the area of tax analysis. Major taxes can be incurred as farm assets are liquidated. These taxes can be incurred if assets are sold, if assets are deeded to a creditor in lieu of foreclosure, or if debt is being forgiven. Taxes can also be incurred if there is a projected change in the organization of the farm business. This tax analysis is essential for successful farm financial planning.

Many attorneys also have the needed expertise in farm financial management. Attorneys should be asked to review financial, estate and business organization documents. These include not only documents which have been signed but also those which are being proposed.

As alternatives are explored, the legal counsel should be preparing or reviewing any new agreements. It is certainly possible to prepare new agreements that reflect compromises. The attorney should be active both in the negotiations with other parties and in reviewing and preparing agreements reflecting the negotiated terms.

Attorneys will be needed

if there is a decision to file bankruptcy. All of the procedural steps involved in a bankruptcy certainly require the expertise of a person trained in dealing with the court and other legal procedural matters.

Another group of counselors who are available to help farm families, are those trained in the emotional and psychological effects of financial stress. Financial difficulties impact greatly on personalities and emotions. Emotional and psychological concerns are a common aspect of financial stress. Individuals trained in dealing with these matters can be of great assistance to the farm family.

FEE PAYMENT

A very legitimate, and important, question which is always asked is "how do I pay for all of this additional help?" This question should be shared with the counselors themselves. If the help is needed, the counselors can help to budget the source of the money for payment. Some of the counselors are paid from outside sources and will not be a direct expense to the farm family. Other counselors depend on the fees from their work to meet their own financial needs. There should always be a discussion of the fees and how they are to be paid. The earlier this discussion in the relationship, the better.

Sources of income for fee payment need to be explored. Sources include selling of assets, income generated from the farm in the future, income from an outside job, custom work, gifts from others, and additional loans are also options. Often it is very difficult to find assets which are not already pledged to a current creditor. Fee payment is a valid concern and needs to receive up front attention.

APPOINTMENTS

Time can be saved if the appropriate information is taken to early appointments with counselors. Information which will be needed includes: a current, "realistic" financial statement; a list of creditors, including their name, address, amount of debt owed, security offered, and the terms of the loan; an estimate of family living costs; a farm budget for the next twelve months if the farm is to continue in operation; a list of assets including the value of each; the past three years income tax returns for analysis of income history, net operating loss carry forward, investment tax credit carry forward, and recapture potential; family goals for the future; and other papers such as life insurance policies, pending lawsuits, information on a potential inheritance, vehicle titles, and leases.

SUMMARY

The obtaining of professional counsel is essential for successful management of farm financial difficulties. Plan to take time in selecting a team of counselors. This time is

worth it by way of peace of mind, assistance acquired, goals accomplished, and money saved.

THE DEBTOR/CREDITOR RELATIONSHIP

It is so easy to create a debtor/creditor relationship. Money is borrowed in the most informal of relationships as well as in formal arrangements where considerable thought and negotiation go into the loan agreement. Money is borrowed when an item is purchased and an oral statement is made that, "I'll pay you tomorrow"; when a check is given but it has not yet cleared the bank; when a seller extends a loan to a buyer; or when money is borrowed and a full compliment of loan papers are signed.

At times any person or business will be both a creditor and a debtor. For farmers it is normal to think of being a debtor if money is borrowed for production inputs or for capital purchases. However, there are many instances when a farmer will also be a creditor. A farmer selling products is a creditor until the check received has cleared the bank. If a farmer rents assets, a credit relationship exists until payment is received. If a farmer does custom work, credit is extended until payment is received. Also where a parent (farmer) loans money to a child, there is a debtor/creditor relationship.

The definitions for creditor and debtor have two basic sources: state law (state statutes and court decisions) and federal law (bankruptcy statutes and court decisions). A creditor is one who extends credit, expecting to be repaid, and to whom money is due.1 An Ohio case defines creditor broadly as, "one who has a right to recover money from another on any account whatever".2

Under federal law, emphasis is placed upon the term "claim" when defining creditor or debtor. Bankruptcy law is the primary reference for federal debtor/creditor law. Bankruptcy law defines a claim as a right to payment regardless of the status of that right.3 The right to payment need not be reduced to judgment. It may be disputed or undisputed, matured or unmatured, liquidated or unliquidated, secured or unsecured, fixed or contingent, legal or equitable.

The term "claim" includes the right to a fair remedy upon failure of performance of a contract if the breach gives rise to a right to damages or payment. A creditor, under federal law, is an entity possessing a claim against a debtor which arises before a bankruptcy order is issued.4

Debt refers to liability on a claim.5 A person against whom a claim has been raised is a debtor.6 Ohio defines debtor very broadly as the person who owes payment or other performance.7

CLASSIFICATIONS OF CREDITORS

There are various types of creditors. The

classification of a creditor affects his/her legal status. The classification affects the steps a creditor must take to collect on a loan once collection has become a problem. The classification of a creditor also determines if the money owed is collectible when the debtor has limited funds. In addition, the classification of a creditor determines the status of a creditor compared to other creditors and the rights of the creditor as to a trustee in bankruptcy. Creditors should understand the various classifications and purposefully place themselves in the classification desired and feasible.

Federal bankruptcy law has abolished the use of classification by creditor type, classifying instead on the basis of the underlying claims.8 Bankruptcy law uses the terms "secured creditor", "unsecured creditor", and "priority claims".

Under Ohio law creditor claims are classified as follows: general creditors, unperfected secured creditors, perfected secured creditors, mortgage creditors, judgment holders, mechanics' lien holders, warehouse lien holders, artisan lien holders and tax lien holders. Each classification of creditor has different collection rights and procedures.

General Creditor

A creditor who has a promissory note with a debtor but has taken no steps to establish a security interest in the debtor's assets is a general creditor. In the operation of a farm business, a general creditor relationship is common; input suppliers and cash rent landlords are two prime examples.

The promissory note may be either oral or written. If a creditor is a general creditor, enforcement procedures on an oral note are the same as on a written note. One advantage of the written note is that the terms of the loan are in writing, i.e., the amount of the loan, the date of pay- ments, and the interest rate.

The major difficulty with being a general creditor is in collection. Creditors who have become secured creditors have first claim on identified assets of the debtor. In a financially distressed situation, general creditors often do not receive full payment. Parties who have traditionally been general creditors do not have to accept that status. Procedures are available to create a security interest in favor of the traditional general creditor.

Unperfected Secured Creditor

The unperfected secured creditor has a promissory note with the debtor along with a collateral interest in named assets of the debtor. The creditor and debtor, in addition to the promissory note, prepare a document known as a security agreement. In the security agreement, the debtor pledges certain assets to the creditor in case payment is not

made or other default occurs.

The difficulty with being an unperfected secured creditor is that other creditors may have a security interest in the same assets and may have taken the required steps to become perfected. When financial difficulties arise, the unperfected secured creditor may have no greater ability to collect than the general creditor. The security agreement is a private contract between the debtor and the creditor but the necessary steps were not taken to alert third parties of the security interest.

Perfected Secured Creditor

The perfected secured creditor has a promissory note, security agreement and has taken additional steps to notify third parties of the security interest in the identified assets. Actually, this class of creditors has done everything possible to insure they have a claim on the identified assets if default occurs. In case of financial difficulties this group of creditors has the greatest assurance of collection.

There may be more than one perfected secured creditor who has identified the same assets as security. In case of collection difficulties, the creditor who became perfected first, assuming the filed financing statement has not expired (5 years), will have first rights to the assets. It is possible for all, some, or none of the creditors perfected in the same assets to be in a position of being fully secured. It could be, as is often the case, that the total outstanding debt against the named collateral is greater than the worth of the assets.

The situation of having more than one creditor perfected in the same asset is where the terminology of first lien holder, second lien holder, third lien holder, etc. originates. In case of liquidation of the collateral the creditors are paid in the order of priority.

Mortgage and Land Contract Creditors

Mortgage creditors are similar to perfected secured creditors, except the pledged asset is real estate. In this case, the parties have executed a promissory note and a mortgage. The mortgage describes the real estate pledged to secure the loan. There may be first, second and third mortgage holders.

The land contract creditor has a security interest in real estate also. In a land contract sale of real estate, the seller finances the purchase and keeps the deed in his/her name until the conditions set forth in the contract are met by the debtor (buyer). Once all conditions are met, the deed is transferred to the buyer. If the conditions of the loan are not met, the seller (creditor) would have a right to repossess the real estate subject to any state law

limitations. It is possible for seller financed real estate to be completed with either a land contract or a mortgage.

Judgment Creditor

When creditors have collection difficulties, they may go to the court to obtain a judgment against the debtor. This establishes the authority or approval of the court for the collection process. The court provides the setting for the debtor to raise arguments against the creditor; i.e., there is no debt, the total amount of the debt is inaccurate, other terms of the loan agreement are different than claimed by the creditor, or the goods provided by the creditor were faulty.

A judgment does not assure collection. A judgment creditor cannot establish a priority in assets superior to prior perfected secured creditors or mortgage holders. Once a judgment is obtained, it is up to the creditor to levy on assets, seize property, or garnish the earnings of the debtor.

Mechanics' Lien Creditor

Mechanics' lien creditors have established a security interest in real estate of the debtor. These are creditors who have made an improvement to real estate, are experiencing collection problems, and are taking steps to establish a right in the improvement. The law provides a means for such creditors to record a mechanics lien within a specific time after the work is completed; thus establishing a valid claim on the real estate where the improvement was made.9 The concept is that the creditor improved the value of the property and should be able to place a claim against that value. The claim of these creditors is subordinate to the claims of prior recorded mortgages, fixture filings and prior recorded mechanics' liens.10

Artisan Lien Creditor

The artisan or repairman lien creditor is very similar to the mechanics' lien creditor except the property is personal rather than real. For example, repairs on a tractor. If work is completed, value is added, on an item of personal property the artisan lien creditor has a right to hold the property until payment is made. If no payment is made then the lien holder can take steps as provided by law to sell the property.11 The artisan lien holder, like the mechanics' lien holder, is subordinated to perfected liens in the same property.12

Tax Lien Creditor

If taxes are not paid, the taxing authority has the right to place a tax lien on property. The subject property may be either real or personal. In the case of income taxes, employment taxes, or sales taxes, the lien is subordinate to prior recorded liens on the same property.13 In the case of the real estate tax, the lien attaches to the real estate and underlying the owner's interest therein.14 The State has a continuous first

priority lien on the described land.15 In other words, property tax liens take precedence over all other claims regardless of date of filing. The State may require postponement of all private liens until its demands are satisfied.16

SUMMARY

The debtor/creditor relationship is often established in very casual terms. However, it is possible for the relationship to be formalized and documented with detailed agreements. The body of law addressing this relationship is well developed. Most debtor/creditor legal concerns are under the jurisdiction of State law. The major exception to state law is the Federal Bankruptcy Code. Once a bankruptcy is filed the bankruptcy code governs the debtor/creditor relationship.

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1. State ex rel Saxbe v. Brand, 176 Ohio St. 44, 197 N.E. 2d 328, 330 (1964).

2. Baker v. Herrlinger, 16 O. App. 253 (1922).

3. 11 U.S.C., Section 101(4).

4. 11 U.S.C., Section 101(9).

5. 11 U.S.C., Section 101(11).

6. 11 U.S.C., Section 101(12).

7. O.R.C. 1309.01(A)(4); U.C.C. 9-105.

8. Collier on Bankruptcy, 15th Ed., para. 506.04.

9. O.R.C. Chapter 1311.

10. 68 OJur 3d, Mechanics' Liens Section 127.

11. 66 OJur 3d, Liens Section 15.

12. 66 OJur 3d, Liens Section 31.

13. I.R.C. 6323.

14. 51 OJur 2d, Taxation Section 401.

15. O.R.C. 5721.10.

16. 51 OJur 2d, Taxation Section 405.

PROMISSORY NOTES

Whenever a farmer obtains credit for operating expenses or for the purchase of property, he/she is confronted with paperwork. The legal documents, important to the borrower as well as the creditor, deserve attention so all may be better informed. In addition to the net worth and cash flow and other financial statements requested by creditors to determine repayment ability, there are legal agreements to be reviewed and signed.

There are four documents that deserve attention when farm chattels are offered as security. These include the promissory note, the security agreement, the financing statement, and the notice to buyers of farm products. Clearly, there are other documents that may be used in farm financing, but an understanding of these four results in a much greater awareness of the debtor and creditor legal relationship.

Documents to be considered in real estate financing are the mortgage and land contract. Real estate mortgages are similiar in purpose to the security agreement and financing statement used for personal property.

The laws related to mortgages are found in the Ohio Revised Code at Chapters 5301 and 5302. The laws related to land contracts are found in the Ohio Revised Code at Chapter 5313.

The law that pertains to the discussion of the legal documents signed when negotiating a loan for personal property is found in the Uniform Commercial Code (UCC). The UCC has been adopted in 49 states, all except Louisiana, and has remained basically unchanged since 1972. Ohio's UCC can be found in the Ohio Revised Code at Title 13. Case law has developed around the UCC supplementing and complimenting the Code. It is the total of the Uniform Commercial Code law that is of primary importance in the relationship between debtor and creditor.

The focus for the remainder of this section is on the promissory note, some common provisions found in such notes, the value of a promissory note as a negotiable instrument, and the protection afforded by the promissory note.

THE PROMISSORY NOTE

A promissory note is an unconditional promise to pay a sum certain on a fixed date or dates to a designated payee. Promissory notes may be written or oral. Written notes are preferred for several reasons; the terms are more definite, evidence to support a court enforcement of collection is more determinable, the statute of limitations for collection is longer and a written note may be made negotiable.

In regards to the statute of limitations, an oral contract is enforceable under Ohio law for up to six years after it was performed.1 A written contract is enforceable for fifteen years after the established date of performance.2

For a note to be negotiable it is meant that it can be sold for a price to a bona fide purchaser who then possesses the same rights against the borrower as the original lender. Though a note need not be negotiable to be a note, failure to attain or preserve the negotiable status of a note can render the document less valuable in the credit market. Establishing and preserving the negotiability of notes is of greatest importance to commerical creditors. It would be rare for a private note to be negotiated.

For a note to be negotiable, it must be in writing, be signed by the maker, contain an unconditional promise to repay a sum certain in money with no other promises included, and be payable either to order or to bearer.3 The first three requirements (in writing, signed, and unconditional) are obviously necessary for the note to be negotiable. In addition, the amount to be repaid must be readily apparent from the face of the note and payable in money (defined as any medium of exchange recognized by any government).

There may be a time specified on the face of the note as to when it must be paid or it may be payable upon demand of the holder. The holder may include a later purchaser such as the bank in the preceding example. If no time is specified as to when the note must be paid, it will be deemed payable at any time upon demand of the holder.4

A note payable to the order of a certain designated party (payee) is called order paper and can only be presented for payment by that payee or by the payee to whom the note was assigned. If no such payee is designated or the word bearer is used in the designation, anyone bearing the paper (in possession of it) can present it to the maker for payment when due.

Cognovit Clauses

The Uniform Commercial Code permits certain other clauses to be included in a negotiable promissory note. One of those clauses is known as a cognovit provision. A cognovit note (one containing a confession of judgment clause) is an extraordinary note authorizing an attorney to confess judgment against the maker upon failure to make payment. This clause deprives the debtor of all defenses and rights upon default including the right to notice and a hearing to explain why the obligation was not paid when due. Cognovit notes are commonly used in agricultural lending.

This provision means

that upon default, the creditor and his attorney may obtain a judgment against the debtor on the note without the debtor's knowledge.5 The judgment would allow the creditor to proceed to levy on the debtors property in satisfaction of that judgment. Ohio law does not permit such cognovit provisions in consumer transactions, which are any transaction entered into primarily for personal, family or household purposes.6 For business transactions the law permits cognovit provisions. Courts have held they are not necessarily a violation of the debtors constitutional right of due process.

The U.S. Supreme Court recognizes the validity of such provisions provided they are entered into knowingly and the debtor has waived his rights only after being fully informed as to the effect of the cognovit provision.7 In Ohio, lack of prior notice is not sufficient grounds for reversal of a judgment obtained through a cognovit agreement if the agreement consituted a valid waiver of due process rights. Such a waiver occurs when the promissory note is signed.

The following statement must appear in bold letters on any note containing the cognovit provision:

--WARNING--
BY SIGNING THIS PAPER YOU GIVE UP YOUR RIGHT TO NOTICE AND COURT TRIAL. IF YOU DO NOT PAY ON TIME A COURT JUDGMENT MAY BE TAKEN AGAINST YOU WITHOUT YOUR PRIOR KNOWLEDGE AND THE POWERS OF A COURT CAN BE USED TO COLLECT FROM YOU REGARDLESS OF ANY CLAIMS YOU MAY HAVE AGAINST THE CREDITOR WHETHER FOR RETURNED GOODS, FAULTY GOODS, FAILURE ON HIS PART TO COMPLY WITH THE AGREEMENT, OR ANY OTHER CAUSE. [Sec. 2323.13. O.R.C.]

Acceleration Clauses

Another common clause in most promissory notes is the acceleration clause. Such clauses are prevalent in commercial lending and acceptable in the eyes of the law in order to protect the creditor against adverse changes in the degree of risk prior to maturity.

The Uniform Commercial Code says that the note is considered payable at a definite time even if it is subject to a possible acceleration.8 Acceleration may be made automatic upon the happening of some event, or at the option of the holder, or it may arise upon the violation of the terms of a security agreement or other separate agreement. Typical acceleration clauses provide for the acceleration of payment upon the happening of default (as described in the security agreement), any impairment of the collateral by the debtor, or if the creditor, deems him/herself insecure.

Extension Clauses

In contrast to the right to accelerate is the right to extend the date of payment to some later time. An instrument is not rendered non-negotiable if it is payable

at a definite time subject to an extension at the option of the lender, or to an extension to a further definite time at the option of the borrower.9

While extensions on maturity dates may well affect the liability of any cosigner, the maker is not discharged by the operation of such a provision. The liability of cosigners, indorsers and guarantors will be addressed at length in a later section.

SUMMARY

A promissory note is important in the making, collecting, and enforcing of payment on loans. There are certain requirements set forth by law for promissory notes, especially written promissory notes. A written promissory note is a requisite to valid security agreements, financing statements, mortgages, and notices to buyers. Samples of a cognovit and a non-cognovit note are shown on the next two pages. Study their provisions and wording carefully before taking out your next loan.

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1. O.R.C. 2305.07.

2. O.R.C. 2305.06.

3. O.R.C. 1303.03(A).

4. O.R.C. 1303.07, U.C.C. 3-108.

5. Black's Law Dictionary, 5th Ed..

6. O.R.C. 2323.13.

7. D.H. Overmeyer Co. v. Frick, 405 U.S. 174 (1974).7.

8. O.R.C. 1303.08, U.C.C. 3-109.

9. O.R.C. 1303.08, U.C.C. 3-109.

COGNOVIT PROMISSORY NOTE

$_____ _____, 19____

FOR VALUE RECEIVED, the undersigned, jointly and severally if more than one, promise to pay to the order of _____ _____ at _____, Ohio, or at such other address as the holder hereof may from time to time designate in writing, the principal sum of _____ _____ Dollars ($_____) with interest thereon at the rate of _____ percent(_____%) per annum. The principal sum and interest shall be due and payable as follows:_____ _____ _____ _____ and shall be paid in full on or before _____, 19_____. All or any part of the principal sum and accrued interest may be prepaid at any time without penalty.

This note is secured by a mortgage on real property. Upon default in payment of any installment within _____ calender days after the same is due, or upon failure to perform any of the covenants or conditions contained in said mortgage, this note shall, at the option of the holder hereof, bear interest thereafter at the rate of _____ percent (_____%) per annum, and the entire principal hereof then remaining unpaid, together with all accrued interest, shall, at said holder's option, become immediately due and payable without any notice or demand.

All persons now or hereafter liable for the payment of the principal or interest due on this note, or any part thereof, do hereby expressly waive presentment for payment, notice of dishonor, protest and notice of protest, and agree that the time for the payment or payments of any part of this note may be extended without releasing or otherwise affecting their liability on this note, or the lien or any mortgage securing this note.

The undersigned, and each of them, hereby authorize any attorney at law to appear in any court of record in any county in the State of Ohio, or elsewhere, where any of the undersigned resides or signed this note, after the obligation evidenced hereby, or any part thereof, becomes due and is unpaid, and waive the issuance and service of process and confess judgement against any or all of the undersigned in favor of the holder of this note for the amount then appearing due, together with the costs of suit, and thereupon to release all errors and waive all right of appeal and stay of execution, but no judgment or judgments against less than all of the undersigned shall be a bar to any

subsequent judgment against those of the undersigned whom judgment has not been taken.

This note was executed in _____ County, Ohio.

WARNING: BY SIGNING THIS PAPER YOU GIVE UP YOUR RIGHT TO NOTICE AND COURT TRIAL. IF YOU DO NOT PAY ON TIME A COURT JUDGMENT MAY BE TAKEN AGAINST YOU WITHOUT YOUR PRIOR KNOWLEDGE AND THE POWERS OF A COURT CAN BE USED TO COLLECT FROM YOU REGARDLESS OF ANY CLAIMS YOU MAY HAVE AGAINST THE CREDITOR WHETHER FOR RETURNED GOODS, FAULTY GOODS, FAILURE ON HIS PART TO COMPLY WITH THE AGREEMENT, OR ANY OTHER CAUSE. [Sec. 2323.13 O.R.C.]

_____ Maker

_____ Maker

_____ Maker

_____ Maker

*Note: This Promissory Note is to be used when the obligation of the Maker is secured by a mortgage on real property.

PROMISSORY NOTE

$_____ _____, 19_____

FOR VALUE RECIEVED, the undersigned, jointly and severally if more than one, promise to pay the order of _____ _____ at _____, Ohio, or at such other address as the holder hereof may from time to time designate in writing, the principal sum of _____ _____ Dollars ($_____) with interest thereon at the rate of _____ percent (_____%) per annum. The principal sum and interest shall be due and payable as follows:_ _____ _____ _____ and shall be paid in full on or before _____, 19_____. All or any part of the principal sum and accrued interest may be prepaid at any time without penalty.

This note is secured by a mortgage on real property. Upon default in payment of any installment within _____ calender days after the same is due, or upon failure to perform any of the covenants or conditions contained in said mortgage, this note shall, at the option of the holder hereof, bear interest thereafter at the rate of _____ percent (_____%) per annum, and the entire principal hereof then remaining unpaid, together with all accrued interest, shall, at said holder's option, become immediately due and payable without any notice or demand.

All persons now or hereafter liable for the payment of the principal or interest due on this note, or any part thereof, do hereby expressly waive presentment for payment, notice of dishonor, protest and notice of protest, and agree that the time for the payment or payments of any part of this note may be extended without releasing or otherwise affecting their liability on this note, or the lien or any mortgage securing this note.

This note was executed in _____ County, Ohio.

_____ Maker _____ Maker

_____ Maker _____ Maker

*Note: This Promissory Note is to be used when the obligation of the Maker is secured by a mortgage on real property.

THE SECURITY AGREEMENT, MORTGAGE, AND LAND CONTRACT

SECURITY AGREEMENT

To obtain a loan the borrower will usually be asked to pledge property (collateral) as security. The primary focus of this section is the document called a security agreement. The Uniform Commercial Code within Article 9 sets forth the law of secured transactions. Those UCC provisions are written into the Ohio Revised Code at Chapter 1309.

Most agricultural businesses have three types of debt: long term, intermediate term (longer than one year, but less than ten years) and short term (usually one year or less). Long term debt generally is secured by a mortgage on real property. Intermediate and short term debt are usually secured by personal property or fixtures. It is possible for short and intermediate term debt to also be secured by a mortgage on real estate, frequently in the form of a second or third mortgage.

The definition of a security interest is crucial. It means an interest in personal property or fixtures which secures payment or performance of an obligation. The security agreement is nothing more than the creditor's leverage which insures that the debtor's promises will be fulfilled. The creditor has a right to the property or collateral if the borrower cannot pay the loan or meet other terms of the loan agreement.

Collateral Description

The collateral described in a security agreement can be specific identifying certain items or it can be an encompassing description. For example the described collateral may be one item of farm equipment, certain livestock, or a more encompassing description such as all equipment, all livestock, or all crops to be grown and proceeds therefrom or a totally encompassing description stating: crops, growing crops, livestock, farm products, equipment, inventory, fixtures, contract rights, accounts, general intangibles existing or hereafter acquired, and proceeds therefrom.

Most of the items in this encompassing agreement need no additional explanation; others need to be defined to help in their identification. This encompassing definition is inclusive of most items in the farm business. The definitions of farm products, equipment, inventory, fixtures, contract rights, and general intangibles are given below.

Ohio's definition of farm products has three parts (1) the goods must be crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock, in their unmanfactured state; (2) they must be in the

possession of the debtor; and (3) the debtor must be engaged in raising, fattening, grazing or other farming operations. This definition also says that if goods are farm products they are neither equipment nor inventory.1 Congress defined farm products in a slightly different manner in the 1985 Farm Bill but the Ohio definition is believed to be still relevant.2 This Ohio definition would include items such as stored crops, feeder livestock, breeding livestock, stored fertilizer to be used on the farm, stored feed to be fed on the farm, milk, and wool.

Equipment is defined as goods used or bought for use primarily in business, including farming ... or if the goods are not included in definitions of inventory, farm products, or consumer goods.3 Farm equipment and machinery fit this definition.

Inventory is defined as goods held for sale or lease or to be furnished under contracts of service or if so furnished, or if they are raw materials, work in process, or materials used or consumed in a business.4 This definition includes some of the same items as farm products, however, note the farm products definition says if goods are considered as farm products they can not be considered as inventory. As a result, very few items on the farm qualify as inventory for security descriptions.

Fixtures are goods which become so related to particular real estate that an interest in them arises under real estate law.5 There are several examples of goods which may become fixtures on a farm; tile, grain storage bins, grain legs, milk tanks, silos, etc. These items are purchased after the real estate is already owned and are being added as improvements. Describing fixtures in a security agreement allows the creditor financing the improvement to obtain a security interest in the respective collateral. This interest, if properly executed, can take priority over a prior recorded real estate mortgage holder.6

A contract right is any right to payment under a contract not yet performed.7 Contract rights in farming could be a contract to do custom work, or a contract to receive payment from ASCS upon the meeting of the terms of a farm program.

Intangibles represent property which is a 'right' rather than a physical object.8 Stocks and bonds are examples. The Ohio Revised Code definition is inclusive and basically says general intangibles are all personal property not defined elsewhere.9

The Creation of an Enforceable Security Interest -- Attachment

Attachment (or creation) is the process by which the security interest in favor of the creditor becomes effective against the debtor. The creditor is usually known as

the secured party (the person, lender, seller, or creditor in whose favor the debtor establishes a security interest). The security interest is created as a consequence of a consensual and volitional act10 (borrower's voluntary consent) of the debtor.

There are three basic prerequisites which must be satisfied for a security interest to attach.11 The security interest is not created until all three prerequisites have been met. The prerequisites can be satisfied in any order. When the last prerequisite is met the security interest attaches and becomes enforceable.12

The three basic prerequisites13 are: (1) a security agreement has been signed by the debtor or the creditor has possession of the collateral in accordance with an agreement; (2) the secured party must give value to the debtor; and (3) the debtor has rights in the collateral.

Note that the first requirement states that there shall be a security agreement or possession of the collateral by the secured party. For most farm assets possession cannot be given to the secured party. The secured assets are needed for the farming operation. Possession of collateral by the secured party works for items such as stocks, bonds, or Certificates of Deposit.

Value is given by the secured party when the secured party acquires rights in return for a binding commitment to extend credit or for the extension of credit immediately whether or not the credit is drawn upon.14 In general, value is any consideration sufficient to support a contract.15

The third prerequisite is that rights to the collateral must rest with the debtor.16 This is worded to permit security agreements on assets owned or leased by the debtor. It is possible for the lessor to have a security agreement identifying leased items. In such case the title to the leased items would be held by the lessor but the lessee would have rights to the use of them.

The purpose of a security agreement is to create rights and responsibilities between the debtor and the creditor. The security agreement does grant to the secured party an interest in the collateral that is described. The security agreement is effective according to its' terms between the parties, against purchasers of the collateral, and against other creditors.17

The Form of a Security Agreement

A security agreement itself must meet certain tests for it to be effective. Three statutory criteria must be met: (1) the agreement must be in writing; (2) the debtor must sign the security agreement; and (3) the collateral must be described.18 The 1985 Farm Bill added another formal requirement to farm security agreements;

that is, the security agreement must explictly include the right to notify purchasers of farm products of the existence of the security agreement. If this right to notify is not in the security agreement, creditors lose their right of having a penalty levied against farm debtors who sell collateral to someone not on the list of buyers provided to the creditor.19

1) The Writing--No special form or wording is required to create a security interest; however, it is necessary that an attempt to grant or create a security interest be set forth by the parties in the written agreement.20

Unless the parties stipulate differently the security agreement gives the secured party the right to proceeds21 from the collateral.22

The rights of the creditor in the collateral are created upon default by the debtor. As a result all the parties should understand what constitutes default of the agreement, particularly since the secured party, unless otherwise agreed, has the right to take possession of the collateral without judicial process.23 That is assuming possession can be taken without breaching the peace. This will be discussed in more detail under enforcement on loans in default. The only place where default is defined is within the security agreement, there is no statutory definition of default.

A security agreement needs to be tailored to the parties' wants and needs; the use of standard or preprinted security agreement forms may not meet each party's wishes. Many different terms may be covered within the security agreement such as: the amount of indebtedness secured; the location of the collateral; insurance that is to be carried on the collateral; the care that is to be taken of the collateral; and restrictions on the sale or transfer of the collateral. A major item to remember when drafting or signing a security agreement is, except for the procedure for enforcement upon default, the parties can include whatever they wish in the agreement.

2) The Debtor Must Sign the Security Agreement-- Failure of the debtor to sign the security agreement precludes attachment of the interest in the collateral.24 Note that only the debtor is required to sign the security agreement.

3) The Collateral Must be Described-- When the security interest covers crops, growing or to be grown, or timber to be cut a description of the real estate on which they are growing must also be included in the description25. Any description of personal property is sufficent whether or not it is specific if it reasonably identifies the property.26 A description which will enable third persons to identify the

property covered aided by inquiries which the instrument indicates and directs is sufficient.27

MORTGAGE

A mortgage is frequently defined as a conveyance of real property to secure the performance of some obligation, conditioned to become void on the due performance of the obligation.28 The courts in Ohio now treat a mortgage conveyance as a conveyance of the bare legal title to the mortgagee (lender) solely for the purpose of enabling him to enforce payment.29 Accordingly, the present view is that until breach of the contract, the legal and equitable title to the mortgaged property remains in the mortgagor's (borrower) possession.30 Upon breach of contract the legal title passes to the mortgagee subject to the mortgagor's equity of redemption.31 The mortgagor would have a right to correct any default and reestablish legal and equitable title. Even after a breach of the mortgage terms the possession of the property remains with the mortgagor.32

The law related to mortgages is addressed in Chapters 5301 and 5302 of the Ohio Revised Code. Mortgages relate to real property and therefore are not covered by the Uniform Commercial Code.

Mortgages are to be recorded in the county recorder's office where the land is located.33 Mortgages themselves are not negotiable instruments but the promissory note which accompanies a mortgage is usually negotiable. (Promissory notes are described in an earlier section of this publication.)

The terms of a mortgage may be quite simple as shown in the form at the end of this section, however usually quite detailed terms are written into the mortgage including a reference to the promissory note, a statement that the property is free and clear of all encumberances, a statement that the mortgagor will pay the taxes and liens, a requirement that the mortgagor carry insurance, a requirement that the premises be maintained, a definition of what constitutes default, and possibly other terms. The terms may also prohibit the transfer of mineral rights, timber rights, etc.

The necessary language to be included in a mortgage is set forth in the form at the end of this section. A mortgage is to be signed by the grantor, witnessed by two parties, and notarized.34

Upon full payment of a mortgage the mortgagor should request that a release be filed in the county courthouse.35 A properly executed release will clear the title to the respective real property of the mortgagee's interest.

INSTALLMENT LAND CONTRACTS

An installment land contract is a contract in which the seller of real property agrees to convey title to the buyer when the buyer meets the obligations of the pur-

chase at some future date. Installment land contracts are addressed in the Ohio Revised Code at Chapter 5313. There are several requirements for the contents of a land contract set forth in the Ohio Revised Code Section 5313.02.

Every land contract must be recorded in the county recorder's office where the real estate is located within twenty days after the contract has been signed by both parties.36

Upon default the purchaser of a land contract is subject to having the property forfeited back to the seller. The purchaser has thirty days from the time of any default to correct that default and avoid the forfeiture. If the purchaser of the land contract sale has paid in accordance with the terms of the contract for a period of five years or more from the date of the first payment, or has paid twenty percent or more toward the purchase price, a forfeiture of the property to the seller is not the remedy, instead the seller must follow the foreclosure proceedings set forth by state law.37

SUMMARY

The concept of acquiring a security interest is very important to debtors and creditors. It gives creditors a right in the debtor's property if a default occurs. The security agreement, mortgage, or installment land contract typically define default to include nonpayment. There may well be other identified circumstances that may constitute default such as selling of the collateral, no insurance of the collateral, lack of maintenance on the collateral, or granting another security interest in the same collateral.

To have a valid security interest in personal property or fixtures attachment must occur. Attachment occurs as soon as three events take place: an appropriate agreement that a security interest attach, value is given, and the debtor has rights in the collateral.

Acquisition of a security interest by a creditor can occur by taking possession of certain assets. However, in agriculture the typical security interest is granted by a written security agreement.

There are formal requisites for a security agreement. The agreement must be in writing, must create or provide for a security interest, must be signed by the debtor, and must contain a description of the collateral and if the collateral is crops, crops to be grown, or timber to be cut a description of the underlying real estate.

The next section will address the steps needed to "perfect" the security interest in personal property and fixtures. The first step in obtaining perfection, however, is that there must be a valid security agreement.

1. O.R.C. 1309.07, U.C.C. 9-109.

2. Keith G. Meyer, Congress's admendment to the UCC: The Farm Products Rule Change, 7 Journal of Agricultural Taxation & Law 3 (1986).

3. O.R.C. 1309.07, U.C.C. 9-109.

4. O.R.C. 1309.07, U.C.C. 9-109.4.

5. O.R.C. 1309.32, U.C.C. 9-313.

6. O.R.C. 1309.32(D)(1), U.C.C. 9-313.

7. Black's Law Dictionary, 5th Ed..

8. Black's Law Dictionary, 5th Ed..

9. O.R.C. 1309.01(A)(16), U.C.C. 9-106.

10. The words "consensual and volitional act" are terms of art and they depict the idea that the debtor agrees or consents (consensual) to the creation of a secured interest in collateral in favor of the secured party. The phrase also means that the debtor entered into the act of his own free will (volition).

11. O.R.C. 1309.14, U.C.C. 9-203(1)(a).

12. O.R.C. 1309.14(B), U.C.C. 9-203(2).

13. O.R.C. 1309.14, U.C.C. 9-203.

14. United States v. Cahall Bros., 674 F. 2d 578, 581, (6th Cir. 1982).

15. O.R.C. 1301.01(RR)(4), U.C.C. 1-201(44)(d).

16. O.R.C. 1309.14, U.C.C. 9-203.

17. O.R.C. 1309.12, U.C.C. 9-201.

18. O.R.C. 1309.14(A)(1), U.C.C. 9-203(1)(a).

19. Food Security Act, 131 Cong. Rec. H12388-90, (Cited as 1985 Farm Bill Infra) Sect. 1324.

20. Steego Auto Parts Corp. v. Markey, 2 Oh. App. 3d 200, 441 N.E. 2d 279 (Fulton Cty. 1981).

21. O.R.C. 1309.25 and U.C.C. 9-306 defines proceeds as including whatever is received from the sale, exchange, collection, or other disposition of the collateral. Insurance

payable by reason of the loss or damage to the collateral is proceeds.

22. O.R.C. 1309.14(C), U.C.C. 9-293(3).

23. O.R.C. 1309.46, U.C.C. 9-503.

24. Steego supra. note at page 282.

25. O.R.C. 1309.14, U.C.C. 9-203.

26. O.R.C. 1309.08, U.C.C. 9-110.

27. Lawrence v. Ebarts and Coper, 7 O.S. 195 (1957).

28. 69 OJur 3d, Mortages Section 1.

29. 69 OJur 3d, Mortgages Section 2.

30. 69 OJur 3d, Mortgages Section 2.

31. 69 OJur 3d, Mortgages Section 2.

32. 69 OJur 3d, Mortgages Section 2.

33. O.R.C. 5301.25.

34. O.R.C. 5301.01.

35. O.R.C. 5301.34.

36. O.R.C. 5313.01(C).

37. O.R.C. 5313.07.

SECURITY AGREEMENT

_____
Date

_____
(Name) (Address)

_____
(City or Town) (County) (State)
(hereinafter called the Debtor) does hereby grant, for a valuable consideration, receipt of which is hereby acknowledged unto

_____
(Name) (Address)

_____
(City or Town) (County) (State)
(hereinafter called the Secured Party) a security interest in the following described property and any and all accessions thereto and the proceeds thereof (hereinafter called the Collateral)

DESCRIPTION OF COLLATERAL:

to secure payment of indebtedness of $_____ as provided in the note or notes of even date herewith and also any and all liabilities now existing or hereafter arising, absolute or contingent, due or to become due including all costs and expenses incurred in the collection of the indebtedness and all future advances made by the Secured Party for taxes levied, insurance and repairs to or maintenance of the Collateral.

Debtor hereby warrants and agrees that:

1. The Collateral is or is to be used by the Debtor primarily for (check one):
   (a) Personal, family, or household purposes _____
   (b) Farming operations _____
   (c) Business use _____

2. If the Collateral is or is to be attached to real estate, a description of the real estate is as follows:
_____
_____
_____,
and the name of the record owner is _____.

3. The Collateral will be kept at _____ Street, _____ Ohio, which is the Debtor's residence or place of business. Debtor will promptly notify Secured Party of any change in the location of the Collateral and Debtor will not remove the Collateral from

the above address without the written consent of the Secured Party.

4. The Collateral is (not) being acquired with the proceeds of said note or notes which Secured Party may pay directly to the seller.

5. Except for the security interest granted herein, Debtor is the owner of the Collateral free from any prior lien, security interest or encumbrance, and Debtor will defend the Collateral against all claims and demands of any and all persons at any time claiming the same or any interest therein.

6. Debtor will not sell, exchange, lease, or otherwise dispose of any interest in the Collateral without the written consent of the Secured Party and will not permit any lien, security interest, or encumbrance to attach to the Collateral.

7. No financing statement covering the Collateral is on file in any public office and at the request of Secured Party, Debtor will join with Secured Party in executing one or more financing statements pursuant to the Ohio Uniform Commercial Code in form satisfactory to the Secured Party and Debtor will pay the costs of filing in all public offices wherever filing is deemed necessary by Secured Party. A carbon, photographic or other reproduction of this agreement or a financing statement will be sufficient as a financing statement.

8. Debtor will maintain the Collateral in good condition and repair; will maintain insurance on the Collateral against fire, theft, and such other hazards and in such form and amount as Secured Party may require and for the benefit of Debtor and Secured Party as their interest shall appear; and will pay and discharge all taxes imposed on the Collateral. Debtor assigns to Secured Party all right to proceeds of any insurance not exceeding the unpaid balance hereunder, and directs any insurer to pay all proceeds directly to Secured Party and authorizes Secured Party to indorse any draft for the proceeds. Such policy or policies shall be delivered to the Secured Party and shall be with a company or companies satisfactory to Secured Party.

At its option, Secured Party may discharge taxes, liens, or other encumbrances at any time levied or placed on the Collateral, pay for insurance on the Collateral, and pay for the maintenance and preservation of the Collateral should Debtor fail to do so. Debtor agrees to reimburse Secured Party on demand for any payment so made and until such reimbursement, the amount so

the indebtedness.

Upon happening of any of the following events or conditions: (a) default in the payment or performance of any of the obligations or of any convenant or liability contained or referred to in any note or notes evidencing any of the obligations secured hereunder; (b) loss, theft, destruction, sale or encumbrance of or to the Collateral; (c) death, dissolution, termination of existence, insolvency, business failure, appointment of a receiver of any part of the property of, assignment for the benefit of creditors by or the commencement of any proceedings under any bankruptcy or insolvency laws by or against Debtor; (d) any default under the terms hereunder; or (e) if Secured Party deems itself insecure, Secured Party shall have the rights and remedies of a secured party under the Ohio Uniform Commercial Code, including the right to enter any premises of the Debtor, without legal process and take possession of and remove the Collateral. Debtor agrees, upon request of the Secured Party, to assemble the Collateral, and to make it available at the place designated by Secured Party. Any requirement of reasonable notice of any disposition of the Collateral shall be satisfied if such notice is mailed to the address of the Debtor shown in this Agreement at least ten days before the time of such disposition.

No waiver by Secured Party of any default shall be effective unless in writing nor shall operate as a waiver of any other default or of the same default on a subsequent occasion. Secured Party is hereby authorized to fill any blank spaces hereunder. All rights of Secured Party hereunder shall inure to the benefit of the heirs, executors, administrators, successors, and assigns of Secured Party; and all obligations of Debtor shall bind the heirs, executors, administrators, successors, and assigns of Debtor. If there is more than one Debtor, their obligations hereunder shall be joint and several. This Agreement constitutues the entire agreement between the parties.

_____
Debtor

_____
Secured Party

MORTGAGE

_____ (martial status), of _____ County, _____ for _____ Dollars paid, grant(s), with mortgage covenants, to _____ of _____, the following real property:

(description of land or interest therein and encumbrances, reservations, and exceptions, if any)

(A reference to the last recorded instrument through which mortgagor claims title but the omission of such reference shall not affect the validity of the mortgage)

This mortgage is given, upon the statutory condition, to secure the payment of _____ dollars with interest as provided in note of even date.

"Statutory condition" is defined in section 5302.14 of the Revised Code and provides generally that if the mortgagor pays the principal and interest secured by this mortgage, performs the other obligations secured hereby and the conditions of any prior mortgage, pays all the taxes and assessments, maintains insurance against fire and other hazards, and does not commit or suffer waste, then this mortgage shall be void.

_____, wife (husband) of said mortgagor, releases to the mortgagee all rights of dower therein.

Witness _____ hand this _____ day of _____.

Signed and acknowledged
in the presence of:

_____ _____

_____ _____

STATE OF OHIO
COUNTY OF _____, SS:

Before me, a Notary Public in and for said State and County, personally appeared _____

_____

who acknowledged the signing of the foregoing Mortgage and that the same is the free act and deed of such signatores for the uses and purposes therein mentioned.

IN WITNESS WHEREOF, I have hereunto signed my name and affixed my offical seal on the _____ day of _____, 19____.

_____
Notary Public

Adopted by the
Columbus Bar Association
April, 1982

Chapter 5313 of the Ohio Revised Code contains additional rights and obligations of a Seller and a Buyer under a Land Installment Contract other than those set forth in this Land Installment Contract. Before signing this Land Installment Contract, it is recommended that Seller and Buyer each consult with legal counsel.

LAND INSTALLMENT CONTRACT

_____

(identify marital status), hereinafter called "Seller", whether one or more than one, agrees to sell to _____

_____, hereinafter called "Buyer", whether one or more than one, and Buyer agrees to purchase, upon the following terms and conditions, the real estate improvements, fixtures, and appurtenances known as _____, the legal description of which is as follows (the "Premises"):

Situated in the State of Ohio, County of _____, and _____,

and being further described as follows: _____

_____

_____

§1. **Purchase Price and Payment.** Buyer shall pay Seller for the Premises the Purchase Price, including all fees and charges for services, of $ _____. The Purchase Price shall be payable as follows:

(a) Upon Buyer's execution of this Contract, Buyer shall pay the sum of $_____ as a down payment for the Purchase Price, subject to such adjustments, prorations and credits as provided for hereinafter.

(b) The remaining principal balance of the Purchase Price ($_____), together with accrued interest on the declining unpaid balance at the rate of _____% per annum from the date hereof, shall be paid in consecutive monthly installments of $_____ or more, beginning on the _____ day of _____, 198__, and continuing on the same day of each subsequent month until said balance and accrued interest are paid in full; provided, however, that unless sooner paid the remaining unpaid principal balance and all accrued interest shall be due and payable on or before _____.

(c) The unpaid principal balance on which interest shall accrue shall be adjusted monthly. If Buyer fails to make any installment due under this Contract within 10 days of its due date, a late charge of _____% of such payment shall be charged Buyer

(d) Monthly installments due hereunder shall be paid to Seller at the address set forth below Seller's signature or at such other address as Seller may from time to time designate.

§2. **Possession.** Buyer shall have exclusive possession of the Premises commencing on _____ and continuing thereafter so long as Buyer is not in default under this Contract.

§3. **Real Estate Taxes and Assessments.** Buyer shall pay all real estate taxes and assessments becoming due or payable from or after the date of this Contract.

§4. **Utilities.** Buyer shall pay for all charges incurred for all utility services used or consumed at the Premises from and after the date possession is given to Buyer.

§5. **Indemnity and Insurance; Escrow Accounts.** From and after the date of this Contract, Buyer shall indemnify Seller for, defend Seller against, and hold Seller harmless from any liability, loss, cost, injury, damage, or other expense that may occur or may be claimed by or with respect to any person or property on or about the Premises resulting from the use, misuse, possession, occupancy, or nonoccupancy of the Premises by Buyer or Buyer's agents, employees, licensees, invitees, or guests. Buyer has examined the Premises and is relying solely upon such examination with respect to the condition, character and size of the land, improvements and fixtures, if any, constituting the Premises.

At Buyer's own cost and expense, Buyer shall obtain and maintain in full force and effect at all times during the continuance of this Contract: (a) comprehensive liability insurance for bodily injury or death to any person or persons, and property damage insurance, in such amounts as Seller reasonably deems necessary; and (b) fire and extended coverage insurance in an amount sufficient to prevent Seller from being a co-insured under said policy of insurance, but in no event less than the unpaid balance due under this Contract.

Seller and Buyer shall both be named as insured parties in the insurance policies required above, as their interests appear, and, at Seller's request, Buyer shall obtain a standard mortgagee's endorsement for the protection of Seller's mortgagee. Each policy shall provide for written notice to Seller and Seller's mortgagee, if applicable, at least 30 days prior to any cancellation, modification, or lapse thereof. Buyer shall furnish Seller and Seller's mortgagee, if applicable, with memorandum copies of such insurance policies upon Seller's execution of this Contract.

Seller, at Seller's option, may obtain and maintain the fire and extended insurance policy noted in this §5 (a copy of which shall be delivered to Buyer) and may pay directly the real estate taxes and assessments noted in §3, above, in which event Buyer shall pay to Seller, within 15 days after Seller notifies Buyer in writing of the amount of the same, the amount of such real estate taxes and insurance premiums. If Seller's mortgagee pays the real estate taxes and/or insurance premiums on behalf of Seller, Buyer shall pay, in addition to and at the same time as monthly installments are due Seller under this Contract, the monthly amount payable by Seller to Seller's mortgagee, as such amounts may be adjusted from time to time by Seller's mortgagee.

§6. **Maintenance and Repairs; Use.** Buyer shall maintain and repair the Premises in as good condition and state of repair as the Premises are in as of the date of this Contract, reasonable wear and tear excepted. Buyer shall not make any alterations, additions or improvements to the Premises without the prior written consent of Seller, which consent shall not be unreasonably withheld, nor shall Buyer commit any waste to the Premises. Seller shall have the right, upon at least 24 hours notice to Buyer, to enter upon and inspect the Premises at all reasonable times during the continuance of this Contract. Buyer shall promptly notify Seller in writing of any damage to the Premises which exceeds the amount of the insurance deductible. In the event of a fire or other casualty, and to the extent permitted by any mortgagee of the Premises, insurance proceeds shall be utilized to restore and repair the Premises. Buyer shall not create, permit, or suffer any liens or encumbrances against the Premises, except the lien of current taxes and installments and assessments not yet due and payable.

§7. **Damage and Destruction; Eminent Domain.** From and after the date of Seller's execution of this Contract, neither the destruction of or damage to the Premises, whether from fire or other cause, nor the taking of the Premises or any portion thereof in appropriation proceedings or by the right of eminent domain or by the threat of the same, shall release Buyer from any of Buyer's obligations under this Contract; provided, however, that any awards made for a taking of the Premises shall belong to Seller up to the amount of the unpaid balance of the Purchase Price and accrued interest to the date of such taking, and the amount of such award paid to Seller, or to Seller's mortgagee on behalf of Seller, shall be credited as payments under this Contract. Any excess award shall be paid to Buyer.

§8. **Seller's Mortgage; Encumbrances.** Seller shall pay any mortgage now encumbering or hereafter placed on the Premises by Seller in accordance with the terms thereof. If Seller is in default under any such mortgage, then Buyer may cure such default, and all sums so paid by Buyer shall be credited by Seller as payments under this Contract

The Premises are presently subject to the following encumbrances: zoning ordinances; legal highways; covenants, restrictions, conditions and easements of record; the lien of real estate taxes and assessments not yet due and payable; and (none, if nothing stated)._____

_____

_____

§9. **Completion of Contract and Transfer of Premises.** When the Purchase Price and all other amounts to be paid by Buyer pursuant to this Contract are fully paid, Seller shall convey the Premises to Buyer by transferable and recordable general warranty deed with release of dower, if required (or executor's or trustee's deed if appropriate), warranting good and marketable fee simple title to the Premises, free and clear of all liens and encumbrances whatsoever, except for the following: those which have been created or assumed by Buyer; zoning ordinances; legal highways; covenants, restrictions, conditions and easements of record which do not unreasonably interfere with the present lawful use of the Premises; and the lien of real estate taxes and assessments not then due and payable.

§10. **Title Evidence.** Buyer acknowledges that Seller has, at Seller's expense, provided either an abstract of title or an owner's (land contract vendee's) title insurance commitment (with policy premium prepaid) in the amount of the Purchase Price, showing in Seller marketable title in fee simple, free and clear of all liens and encumbrances except those created by or assumed by Buyer and those referred to in §8, above. If an abstract was provided, Buyer shall deliver the abstract back to Seller upon execution hereof to be kept by Seller until returned to Buyer prior to delivery of the deed. The title evidence provided by Seller under this §10 satisfies all of Seller's obligations to Buyer with respect to title evidence.

§11. **Assignment.** Buyer shall not assign, encumber or transfer Buyer's interest under this Contract without the prior written consent of Seller.

§12. **Buyer's Default.** The entire unpaid balance of the Purchase Price, together with all unpaid and accrued interest and all other charges payable under this Contract, shall at Seller's option become immediately due and payable: (1) if Buyer fails to make any payment within 30 days after it becomes due; (2) if Buyer fails to observe or perform any other provision, covenant or condition required of Buyer within 30 days after Seller gives notice to Buyer of Buyer's failure to observe or perform said provision, covenant or condition; (3) if Buyer abandons the Premises during the continuance of this Contract; (4) if an order for relief under any bankruptcy laws of the United States is issued naming Buyer as debtor or if Buyer makes an assignment for the benefit of creditors or enters into a composition agreement with Buyer's creditors; (5) if the interest of Buyer in the Premises is attached, levied upon, or seized by legal process; (6) if a trustee, receiver or liquidator is appointed on behalf of Buyer; or (7) if this Contract is assigned in violation of its terms or is terminated by operation of law. In any of such events Seller may, upon notice to Buyer as required by law, initiate proceedings for the foreclosure or forfeiture of Buyer's interests in this Contract and in the Premises.

§13. **Nonwaiver; Right to Cure Defaults; Remedies.** Neither the failure by Seller to exercise any of Seller's options hereunder, nor Seller's failure to enforce Seller's rights or seek Seller's remedies upon any default, nor acceptance by Seller of any payments occurring before or after any default shall effect or constitute a waiver of Seller's rights to exercise such option, to enforce such rights or to seek such remedy with respect to that default or to any prior or subsequent default.

If Buyer fails to pay by their respective due dates any charges or other obligations to be paid pursuant to the terms hereof, or fails to perform any other duties which Buyer is required to perform hereunder, then Seller, at Seller's option, may do so and the amount of any such expenditure by Seller, plus accrued interest at the rate of _____% per annum from the time such expenditure is made until reimbursed, shall immediately become due and payable to Seller.

The remedies provided in this Contract shall be cumulative and shall not in any way abridge, modify or preclude any other right or remedies to which Seller is entitled at law or in equity.

§14. **Miscellaneous.**

(a) As used herein the term "Seller" and "Buyer" include, respectively, all persons signing this Contract in the capacity so stated and his, hers or its respective heirs, successors, and assigns, and all obligations of each party herein are joint and several.

(b) This Contract shall be governed by the laws of the State of Ohio, and, if any provision hereof is in conflict with any federal law or law of the State of Ohio, then any such terms shall be deemed modified to conform to such law without affecting the remaining provisions of this Contract.

(c) Seller shall cause this Contract to be recorded within 20 days after it has been fully executed.

(d) Pending orders of any public agency against the Premises are as follows: (none, if nothing stated)

_____

_____

(e) If this Contract is entered into pursuant to a real estate purchase contract, the term "closing" when used in said purchase contract shall for all purposes be defined as the date of execution of this Contract. If there are inconsistencies between the terms of the purchase contract and the terms of this Contract, the terms of this Contract shall prevail.

(f) Additional provisions:

_____

_____

_____

IN WITNESS WHEREOF, the parties to this Contract and their spouses have hereunto set their hands to duplicate counterparts of this contract as of the day and year indicated below.

Signed and acknowledged in the presence of:

SELLER

_____

_____ Dated: _____

Address: _____

_____

_____ Dated: _____

Address: _____

BUYER

_____

_____ Dated: _____

Address: _____

_____

_____ Dated: _____

Address: _____

STATE OF OHIO
COUNTY OF _____, SS:

On this _____ day of _____, 198____, before me, a Notary Public in and for said State, personally appeared the above named _____, Seller, who acknowledged the signing of the foregoing instrument and that the same is Seller's free act and deed.

_____
Notary Public

STATE OF OHIO
COUNTY OF _____, SS:

On this _____ day of _____, 198____, before me, a Notary Public in and for said State, personally appeared the above named _____, Buyer, who acknowledged the signing of the foregoing instrument and that the same is Buyer's free act and deed.

_____
Notary Public

This instrument prepared by _____, attorney at law.

FINANCING STATEMENTS

The third document in our list of four important legal documents is the financing statement (UCC-1). The financing statement is that document which is intended to give notice to the rest of the world of the security interest of the creditor in the described collateral.

Care should be exercised to distinguish the financing statement from financial statements. Financial statements, also called balance sheets or net worth statements, are developed to ascertain the economic status of an entity and are used in business planning and accounting.

When two parties enter into a debtor/creditor relationship and the creditor requires the debtor to sign a promissory note and a security agreement, often a financing statement is also executed. The financing statement is a simple document that evidences the debt between the parties and the collateral pledged as security. The financing statement is recorded in the proper public office. This evidence puts the rest of the world on notice that the described collateral is subject to a lien in favor of the named creditor.

Again, the controlling law concerning financing statements, as well as security agreements, is Article 9 of the Uniform Commercial Code or Chapter 1309 of the Ohio Revised Code.1 A financing statement is sufficient if it lists the names and addresses of the debtor and creditor, if it is signed by the debtor, and gives a description of the collateral or the type of collateral involved.2

The law further requires that if the collateral described is growing crops or crops to be grown the financing statement must also contain a description of the real estate where the crops are growing or to be grown.3 Most county recorder's offices today are accepting for the desription the reference to parcel numbers which have been established by the county auditor's office. Some county recorder's offices are requiring a full legal description with a reference to volume and page number of the deed or mortgage on the respective property.

PERFECTING THE SECURITY INTEREST

The primary reason for filing a financing statement is to perfect the security interest for the creditor. A creditor is secured when the security agreement is signed in conjunction with the promissory note. However, most farmers (debtors) have financial dealings with more than just one creditor. The next step for a creditor having already secured an interest in collateral of the debtor is to "perfect" the interest in relation to other creditors.

The purpose of perfect-

ing a security interest is to establish a position of relative priority among the various creditors. Should the debtor become insolvent or bankrupt, each creditor would like to be able to acquire the described security. Some creditors learn too late that another has priority rights in the same described collateral.

The general rule of priority among conflicting creditors is "first in time, first in right". This means that the creditor who was first to perfect a security interest will be paid before other creditors having perfected later in time. There are, however, several exceptions to this general rule. Those exceptions will be discussed later.

Perfection is obtained when the property attaches as described under security agreements and the proper filing of the financing statement is completed. For some types of property perfection is achieved by the creditor taking possession of the property offered as security. Examples of property which a creditor might take possession of are certificates of deposit and stock certificates. A creditor taking possession of collateral does not work in situations like farming where the debtor needs the use of the collateral to continue operating.

THE PROPER PLACE TO FILE

The proper place to file a financing statement is controlled by the provisions of the Uniform Commercial Code.4 Financing statements are used in the total of commercial and consumer trade not just agriculture. In general, the proper place to file the financing statement is in the office of the Secretary of State and in the county of the debtor's residence. Exceptions to this general rule are made when filing to perfect a security interest in farm products, farm equipment, or consumer goods. In such cases, the appropriate office to file a financing statement is the recorder's office of the county of the debtor's residence.5

When the collateral is growing crops or crops to be grown, the financing statement must be filed in the recorder's office of the county of the debtor's residence and also the county where the crops are growing or are to be grown, if other than county of debtor's residence.6 This additional filing when the crops are grown on land in a county other than where the debtor resides is designed to enable the search for liens against crops grown on specific lands of a county. Without this protection, a search of the records in the county of the location of the crops may reveal no existing security interests because the filing was made in another county (that of the debtor's residence) unbeknownst to the latter creditor.

This uniform system of filing is designed to provide

a convenient system whereby creditors can determine the existence of prior perfected security interests in collateral. This determination must be made so that future creditors will not be placed in a subordinate position relative to others without constructive knowledge.

One exception to the requirement of filing a financing statement to perfect a security interest is when the collateral in question is a titled motor vehicle. This would include cars and trucks. In such case, perfection is achieved by means of a notation of the security interest on the certificate of title in place of filing. A creditor retaining possession of the title will also give notice to other creditors of a priority lien on titled vehicles and is a common practice.

THE EFFECT OF PERFECTION

Proper perfection is an all or nothing venture; either a creditor is fully perfected or not perfected at all. Perfection means that the crediitor has met all statutory requirements: the form is properly completed, the collateral properly described, and the financing statement filed at the proper time and in all the proper places.

DESCRIPTION OF THE PROPERTY

The description of property in the financing statement follows generally the same rules as in the security agreement. The property description in the financing statement cannot be more inclusive than the property described in the security agreement. If it should be more inclusive the description in the security agreement would determine finally what property the creditor had rights to. At the same time if items are left out of the description in the financing statement the creditor will not be perfected in those items.

The description in the financing statement is to put other creditors on alert. The financing statement description could be more general than the security agreement description causing awareness on the part of creditors. Then a review of the security agreement would indicate the particular assets in which a security interest exists. For example, if the financing statement indicated farm equipment and the security agreement indicated a specific tractor the perfection would exist as to that specific tractor, not as to all farm equipment. The description both in the security agreement and the financing statement are very important. Creditors at times have been unable to establish perfection because the description was not adequate.

SUBORDINATE LIEN HOLDERS

It is entirely possible to have creditors in a second, third , or lower lien holder position. This may be done purposefully and knowingly or because an adequate check of other lien holder positions was not made.

The subordinate lien holder positions in specific collateral usually would occur because the date of filing was later in time. It is possible for creditors to purposefully subordinate. For example, a later creditor could say "I will not extend a loan for a specific item unless I can get a first lien holder position on identified collateral". A request could be made to the first lien holder creditor asking for subordination. That creditor may or may not be willing to subordinate.

THE GENERAL RULE: "FIRST IN TIME, FIRST IN RIGHT"

The general rule is that priority is granted to those who file the financing statement first in time. There are some exceptions to this general rule. Basically, the exceptions rely on a concept that a later creditor has extended credit for value added into the business.

This concept is known as a purchase money security interest (PMSI).7 The concept of PMSI relates to credit furnished for the purchase of equipment, inventory, and fixtures. For example, if a farmer purchases a new combine the creditor furnishing the dollars to enable this purchase could acquire a PMSI in that combine, indentifying the combine as the collateral on which the lien exists.

This same rule would apply to an item like a grain bin, a fixture. That creditor could acquire a PMSI naming that grain bin, which becomes attached to real estate, as the collateral, again giving that creditor a priority lien.

There are some definite rules PMSI creditors must follow. The first rule is that new value must be given by the creditor. The second rule is that the security interest must be perfected within 10 days of the debtor receiving possession of the new collateral or in the case of fixtures anytime between the date of possession and within 10 days of the acquired goods becoming fixtures.8

The place of filing a PMSI for items other than fixtures is in the county where the farm debtor resides. The place of filing a PMSI for fixtures is in the county where the real estate is located.9

There is a troublesome provision within the Uniform Commercial Code for crop input suppliers. Fertilizer, fuel, and chemical suppliers often would like to establish a PMSI priority security lien. If new credit has been extended these suppliers would like to be placed in a priority position. Certainly new value has been extended. The Uniform Commercial Code has a special provision for crop suppliers which courts have held to override the general PMSI rule.10

Ohio Revised Code 1309.31 (B) and U.C.C. 9-312(2) states, "a perfected security in crops for new value given to enable the

debtor to produce the crops during the production season and given not more than three months before the crops become growing crops by planting or otherwise takes priority over an earlier perfected security interest to the extent that such earlier interest secures obligations due more than six months before the crops became growing crops by planting or otherwise, even though the person giving new value had knowledge of the earlier security interest". This special rule makes it very difficult for crop input suppliers to obtain a priority lien.

Assuming crops become growing crops on May 1, the obligation on the earlier perfected security interest would have had to been due before November 1 of the previous year. And, the crop input supplier's lien would need to have been put in place in the period between February 1 and April 30.

Many of the obligations falling due more than six months ago would have been renewed, and thus would not not be due until some other date in the future. This makes it almost impossible for crop input suppliers to achieve a first priority lien.

Suppliers of livestock inputs may be able to establish a PMSI. There is no specific code section addressing livestock supplies as there is crop supplies. There is a concern though that feed, like crop supplies, loses its' identity and an effective PMSI is not feasible.

Again, the general rule is "first in time, first in right". However, there is the possibility of later creditors establishing a first priority lien following the rules of purchase money security interests.

DURATION OF FINANCING STATEMENTS

Financing statements are effective for a period of five years from the date of filing.11 Fixture filings may extend beyond five years if the maturity date is stated in the financing statement.12 A creditor may file a continuation statement extending a financing statement's effectiveness beyond the five year basic period. Such a continuation statement must be filed within the six month period prior to the expiration of the five year term.

Fixture filings may also extended if a continuation statement is filed within six months prior to the stated maturity date. Such a continuation statement only needs to be signed by the secured party. The continuation statement has the effect of extending the effective period for another five years.13

TERMINATION OF FINANCING STATEMENTS

Financing statements may be terminated prior to the five year maturity date. Many debtors would like to have the courthouse records

of past financing statements show termination, especially when new credit lines are being established. It is possible for this to occur if the obligations of the earlier financing statement have been met.

For financing statements covering consumer goods the creditor must file a termination statement within one month of the debtor meeting the financial obligations or within ten days following a demand by the debtor after obligations have been met. This time limit for filing a termination statement does not hold for business financing statements.

For business financing statements the creditor must, on written demand by the debtor, send the debtor a termination statement. It then becomes the debtor's responsibility to file the termination statement in the proper county recorder's office. A common practice of creditors is to file the termination statement when the obligation is met.

If the secured creditor fails to file a termination statement for consumer goods or in the case of business goods to send the termination statement within ten days after the demand from the debtor, in case of business goods, the creditor shall become liable to the debtor for one-hundred dollars and for any additional losses experienced by the debtor.14

CHECKING FOR RECORDED FINANCING STATEMENTS

Before accepting a debtor's offered collateral when a new loan is being negotiated, a creditor will want to be assured that no one else has a perfected security interest in the subject property, or at least know what lien status he may be in. Also, debtors may want to know if previously recorded financing statements have been terminated.

There are also times when buyers of assets will be interested in knowing if a lien exists in the items to be purchased. It is possible for a interested party to search the county recorders office for Uniform Commercial Code filings to determine if there are current financing statements on collateral owned by particular debtors. It is also possible for an interested party to ask the county recorder to search their records for current financing statements. The request to the county recorder is made on a UCC-11 form. Requesting the county recorder to do the search is not expensive and can save a person time. However, if one wants the hands on experience of examining original UCC-1 filings it can be done.

SUMMARY

Perfection of security interests is an all important concept for creditors. All creditors would like to be placed in a first lien status when loans are extended. The Uniform Commercial Code has established an extended set

of rules to enable a creditor to check if a first lien status can be acquired and then to achieve this desired lien status.

The general rule, "first in time, first in right", is an important rule. There are exceptions to this rule when new value has been provided by a later creditor for the acquisition of new collateral by the debtor. This exception is provided for in rules for purchase money security interests (PMSI).

Any creditor wishing to establish a priority lien position must have the signed agreements. These include a promissory note, a security agreement, and a financing statement. Upon proper execution and filing of each of these documents a creditor can be placed in a perfected position and be known as a perfected secured creditor.

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1. O.R.C. 1309.01 et. seq..

2. O.R.C. 1309.39(A) and U.C.C. 9-402.

3. O.R.C. 1309.39(E) and U.C.C. 9-402.

4. O.R.C. 1309.38 and U.C.C. 9-401.

5. O.R.C. 1309.38(A)(1) and U.C.C. 9-401(1)(a).

6. O.R.C. 1309.38(A)(1) and U.C.C. 9-401(1)(a).

7. O.R.C. 1309.05 and U.C.C. 9-107.

8. O.R.C. 1309.31(D), U.C.C. 9-312, 1309.32(D) and U.C.C. 9-313.

9. O.R.C. 1309.32(A)(2) and U.C.C. 9-313(1)(b).

10. United States v. Minster Farmers Cooperative Exchange, Inc., 430 F. Supp. 566 (N.D. Ohio 1977).

11. O.R.C. 1309.40(B)(1) and U.C.C. 9-403(2).

12. O.R.C. 1309.40(B)(2).

13. O.R.C. 1309.40(C) and U.C.C. 9-403(3).

14. O.R.C. 1309.41(A) and U.C.C. 9-404.

UNIFORM COMMERCIAL CODE – FINANCING STATEMENT – UCC-1

Revised, Am. S.B. 161, Eff. 3/15/82
anderson publishing co. cincinnati, ohio 45201

INSTRUCTIONS

1 PLEASE TYPE this form Fold only along perforation for mailing

2 Remove Secured Party and Debtor copies and send other 3 copies with interleaved carbon paper to the filing officer Enclose filing fee

3 When filing is to be with more than one office, Form UCC-2 may be placed over this set to avoid double typing

4 If the space provided for any item(s) on the form is inadequate the item(s) should be continued on additional sheets, preferably 8½ ' x 11 Only one copy of such additional sheets need be presented to the filing officer with a set of three copies of the financing statement. Long schedules of collateral, indentures, etc , may be on any size paper that is convenient for the secured party

5 If collateral is crops growing or to be grown, or timber to be cut, or minerals or the like, including oil and gas, or accounts resulting from the sale of minerals at the wellhead or minehead to which the security interest attaches upon extraction, or goods which are or are to be become fixtures, the financing statement must recite that it covers that type of collateral and that it is to be indexed in the real estate records of the county in which the real estate is situated and must contain a legal description of the real estate and, if the Debtor does not have an interest of record in the real estate, the name of the record owner or record lessee (see section 1309 39(E) of the Revised Code)

6 When a copy of the security agreement is used as a financing statement, it is requested that it be accompanied by a completed but unsigned, set of these forms, without extra fee

7 At the time of original filing, filing officer will return third copy as an acknowledgement At a later date, secured party may date and sign the termination legend and use third copy as a Termination Statement

This FINANCING STATEMENT is presented to a filing officer for filing pursuant to the Uniform Commercial Code.

1 Debtor(s) (Last Name First) and Address(es)	2 Secured Party(ies) and Address(es)	3 For Filing Officer (Date, Time, Number, and Filing Office)

4 This financing statement covers the following types (or items) of property:

Check ☒ if covered: ☐ Products of Collateral are also covered No. of additional sheets presented:

Filed with

(USE WHICHEVER SIGNATURE LINE IS APPLICABLE)

By: ..... By: .....
Signature(s) of Debtor(s) Signature(s) of Secured Party(ies)

Filing Office Copy—Alphabetical

This form of financing statement is approved by the Secretary of State

STANDARD FORM –
UNIFORM COMMERCIAL CODE – UCC-1

Revised, Am. S.B. 161, Eff. 3/15/82
anderson publishing co. cincinnati, ohio 45201
REPRINTED 1/84

Uniform Commercial Code — REQUEST FOR INFORMATION OR COPIES — Form UCC-11

INSTRUCTIONS:

1. PLEASE TYPE this form. Fold only along perforation for mailing.
2. Place "X" in appropriate box to designate whether this form is being used as a Request for Information on financing statements and statements of assignment on file, or as a Request for Copies of financing statements or statements of assignment on file.
3. If information or copies are to be requested from different filing officers, separate requests must be submitted to each filing officer.
4. FEES: REQUEST FOR INFORMATION — the fee is $2.00, plus $1.00 for each financing statement and for each statement of assignment reported by filing officer.
   REQUEST FOR COPIES — the fee is $1.00 per page for a copy of any filed financing statement or statement of assignment furnished by filing officer.
5. After typing form, DETACH PART THREE and retain in your files as temporary record of submission of this request. If filing officer returns part one with notation that an additional fee is required, submit this part THREE with payment of additional fee to insure proper credit.

REQUEST FOR INFORMATION OR COPIES — PRESENT IN TRIPLICATE TO **Filing Officer:**

DEBTOR(S) (Last Name First) and address(es):	PARTY REQUESTING INFORMATION OR COPIES: (Name and Address)	FOR FILING OFFICER USE

☐ **INFORMATION REQUEST:**

Filing officer please furnish certificate showing whether there is on file as of _____, 19____ at_____ ____M., any presently effective financing statement naming the above named debtor(s) and any statement of assignment thereof, and if there is, giving the date and hour of filing of each such statement and the name(s) and address(es) of each secured party(ies) therein. Enclosed is uniform fee of $2.00. The undersigned party further agrees to pay to the filing officer, upon receipt of this certificate, the sum of $1.00 for each financing statement and each statement of assignment reported on the certificate.

☐ **COPY REQUEST:**

Filing officer please furnish exact copies of each page of financing statements and statements of assignment listed below, which are on file with your office. Enclosed is fee of $1.00 for each page requested.

Date _____ (Signature of Requesting Party) _____

FILE NO.	DATE AND HOUR OF FILING	NAME(S) AND ADDRESS(ES) OF SECURED PARTY(IES)

CERTIFICATE: The undersigned filing officer hereby certifies that:

☐ the above listing is a record of all presently effective financing statements and statements of assignment which name the above debtor(s) and which are are on file in my office as of_____19_____at_____ ____M.

☐ the attached_____pages are true and exact copies of all available financing statements or statements of assignment listed in above request.

☐ Additional Fee Required $_____

_____ (Date) _____ (Signature of Filing Officer)

STANDARD FORM — UNIFORM COMMERCIAL CODE — FORM UCC-11

TO BE RETURNED WITH COPIES OR INFORMATION

anderson publishing co. cincinnati, ohio 45201
(Reprinted 8/83)

REQUESTING PARTY RETAIN THIS COPY

BUYERS OF FARM PRODUCTS AND FARM MACHINERY

FARM PRODUCTS

On December 23, 1986 Federal law preempted State laws regarding the responsibility of buyers of farm products to their sellers' creditors. State laws for several years had been attempting to give buyers of farm products some measure of protection from security interests granted by their selling customers and the attendent risk of paying twice for the same products -- first to the seller and again to the seller's lender.1

Ohio had enacted legislation in 1983 which offered protection to buyers of farm products. The Federal law which became effective in 1986 resembles very closely the 1983 Ohio law.

Under Ohio law prior to 1983, and most other states' laws, buyers of farm products were concerned whether the farm products being purchased had a perfected security interest or not. The prior law allocated the risk of nonpayment by a farmer to the buyer of secured farm products, not to the creditor. If the farmer/debtor did not use the proceeds from the sale to pay the creditor, creditors had a right to recovery from the buyer.

Under that prior law buyers of farm products were challenged to check county courthouse records to see if a lien existed on the products being purchased. This burden became greater over time with increased mobility of grain and livestock marketing. Farmers often marketed some distance from their county of residence and this created difficulty in conducting U.C.C. searches in the home county of the debtor.2

The 1985 Farm Bill preempted all state laws relating to this concern of buyers of farm products. Therefore, the buyers of farm products portion of the Ohio Revised Code Section 1309.26 and the Uniform Commercial Code Section 9-307 are now governed by Federal law.3

Today, secured parties who wish to protect their security interests against buyers in the ordinary course of business, must (1) request of their debtors a written list identifying the potential buyers of farm products and (2) give written notice of the security interest to such buyers along with the information and instructions regarding payment.

A debtor (1) is required to provide the list of buyers if requested, (2) is prohibited, subject to penalty, from selling farm products to buyers who do not appear on the list, and (3) may amend the list and sell to additional named buyers upon proper notice to the secured parties.

A buyer takes free of a security interest unless (1) he/she has recieved the statutory notice within

twelve months of the date of sale, and (2) it fails to make payment in compliance with the notice(s).4

The provision that buyers can take free and clear if actual notice has been recieved and the instructions on the notice are followed is conditioned on the fact that the sale is in the ordinary course of business.5 A buyer who has knowledge of unusual circumstances when a sale takes place still must exercise care. If the sale does not take place in the ordinary course of business, the buyer may have to reimburse the seller's creditors if the seller does not use the proceeds for making the required payments. Events like hauling farm products to a distant market where there is no market advantage or selling farm products in another party's name and not using the proceeds to pay the loan could cause that buyer to bear the risk of having to pay a second time.

The specific requirements of the notice which is sent to buyers of farm products by creditors includes:

1. name and address of the debtor;
2. social security number of an individual debtor and the taxpayer identification number of farm partnerships and corporations;
3. secured party's name and address;
4. description of the farm products including amount, year of production, and county where produced;
5. conditions under which the secured party will release or waive its security interest such as the issuance of a joint check to the creditor and the debtor;
6. signature of the debtor; and
7. signature of the secured party.

This notice is to be recieved by the buyer within one year prior to the sale. If there is no notice or if the notice is more than one year old buyers of farm products in the ordinary course of business can take free and clear of their seller's lien.

Farmers can change the list of potential buyers. Such changes must be made within seven days of selling the farm products or if the change is not indicated the proceeds of the sale must be delivered to the creditor within ten days after the sale.

Farmers who sell to someone not on the list and fail to deliver the proceeds to the secured creditor within ten days of the sale are potentially subject to a penalty. If the security agreement signed by the farmer when the loan was arranged for asks for the list of potential buyers and ammendments to that list then the creditor could enforce a penalty. That penalty is $5,000 or 15% of the value of the produce sold which ever is greater.

It should be noted that

merchants and selling agents under this law are treated just like the buyers of farm products themselves. For example, if a livestock marketing organization serves as the selling agent creditors would send notice to that selling agent and the agent would have the responsibilities described above.

The Federal law does provide an alternative to this actual notice to buyers of farm products. That alternative was for states to enact centralized filing of farm liens. Centralized filing would require all U.C.C. statements for farm products to be filed with the Secretary of State. Buyers could then be placed on notice through the Secretary of State's office. Ohio is not expected to provide for centralized filing. For a short time in 1983 there was a law that would have required centralized filing of farm liens. At that time the legislature thought it was to expensive too enforce. As a result, the actual notice procedure was put in place in Ohio and will likely continue under the new Federal law.

FARM MACHINERY

Purchasers of farm machinery from a farmer do need to be concerned about the existence of a perfected secured lien. The law provides that buyers in the ordinary course of business can take free and clear of a lien. Farmers are not in the ordinary course of business when they are selling or trading farm machinery.

Therefore, machinery dealers or other buyers acquiring machinery need to be concerned about whether or not there is a perfected secured lien on the item. Usually at farm auctions the auctioneer warrants that there are no liens on the items being sold. Machinery dealers and direct buyers, to have assurance, would have to check the U.C.C. records in the county recorder's office where the debtor resides.

SUMMARY

Buyers of farm products have traditionally been concerned about whether a farmer would use the proceeds of sale to pay secured creditors. Prior to September of 1983 buyers of farm products had the responsibility checking the U.C.C. records to have assurance of being able to buy free of their sellers' liens.

A 1983 Ohio law and the 1985 Farm Bill have provided protection for buyers of farm products. Buyers of farm products under current law can take free of their sellers' liens if they have not recieved actual notice of such lien from the creditor within the twelve months prior to sale or if the payment instructions in any notice received are followed.

Usually the payment instructions call for a joint check issued to the creditor and the farmer (debtor). Any buyer of farm products or farm machinery still needs to be concerned about whether the sale is in the ordinary

course of business. If a party can prove the sale was not in the ordinary course of business the buyer is still at risk that the proceeds will not be used to pay the secured party.

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1. Ohio State Bar Association Report, September 5, 1983, page 1253.

2. Ohio State Bar Association Report, September 5, 1983, page 1253.

3. 1985 Farm Bill Section 1324.

4. 1985 Farm Bill Section 1324(e) and Section 1324(g).

5. 1985 Farm Bill Section 1324(d).

LIST OF POTENTIAL BUYERS OF FARM PRODUCTS

TO: _____
(Secured Party)

_____
(Address)

_____
(City, State, Zip)

I (we) hereby identify all potential buyers of my (our) farm products.

_____ (Name)	_____ (Name)
_____ (Address)	_____ (Address)
_____ (City, State, Zip)	_____ (City, State, Zip)
_____ (Name)	_____ (Name)
_____ (Address)	_____ (Address)
_____ (City, State, Zip)	_____ (City, State, Zip)

(Attach additional sheets or copies of this form if necessary.)

I (we) understand (1) that the farm products may not be sold to any person not named in the list and (2) that the list may be amended in writing received by you not less than 7 days prior to sale to any person identified in the amendment. It is also understood that if a sale is made to someone not on the list and the proceeds are not delivered to the secured party within 10 days I (we) am (are) subject to a penalty of $5,000 or 5% of the loan whichever is larger.

This list is furnished to you as secured party in compliance with 1985 Farm Bill Section 1324 and applies to all present and future security agreements between us which covers farm products.

_____
(Debtor's Name Printed or Typed)

By_____
(Signature of Debtor)

Date_____

NOTICE OF SECURITY INTEREST

DATE: _____
(Date notice is sent)

TO: _____
(Name of buyer)

_____
(Address of buyer)

You are hereby given notice pursuant to Sec. 1324(e) of the Food Security Act of 1985, P.L. 99-198, that:

_____
(Name of secured party)
whose mailing address is:

_____
(Insert complete mailing address)

is the holder of a perfected security interest securing a debt or other obligation of:

_____
(Surname, partnership or corporate name)

_____
(Fisrt name and middle name)

whose mailing address is:

_____
(Debtor's street/rural route, city, state, zip code)

and whose Social Security number, or in case of a debtor doing business other than as an individial, Internal Revenue Service Taxpayer number is:

_____
(SSN/Taxpayer number)

The farm products described in the perfected security interest include:

FARM PRODUCT(S)

_____
(Describe farm product and amount)

_____

CROP/LIVESTOCK YEAR

_____

(For crops grown in the soil the year of harvest, for animals the year born or acquired, for poultry or eggs the year to be sold)

_____

COUNTY(IES) WHERE PRODUCED

_____

OTHER DESCRIPTION

_____

(Add other reasonable description)

THE CONDITIONS UNDER WHICH THE SECURED PARTY WILL RELEASE OR WAIVE ITS SECURITY INTEREST IN THE FARM PRODUCTS ARE AS FOLLOWS:

_____

_____

(Example: "buyer pays for the farm products with a check issued jointly to the debtor and the secured party and such check is honored when presented for payment".)

_____ _____

(Secured party's signature) (Debtor's signature)

COSIGNERS

Lenders often require a borrower (principal debtor) to have a comaker or a surety when making a loan. The reason for this requirement differs with each loan but the purpose is to provide the lender with added assurance that the loan will be repaid. The lender may require a cosigner if a borrower does not have an established credit record or if a borrower has already borrowed to the point where extending additional credit is a high risk. A cosigner may also be required when a loan request is a particularly large one. Another instance when a borrower may be required to have a cosigner is when security for a loan is needed but the borrower cannot secure the loan. Sometimes the lender may require a cosigner even if the loan is fully secured.

Borrowers usually ask parents, other relatives, or close friends to cosign on loans. Parents or friends often feel obligated to sign in order to help their child or friend and may not know or consider the legal obligations they assume when they agree to cosign the loan documents. A parent or a friend who cosigns a note or loan may be considered a comaker or a surety (accommodation party, accommodation maker, guarantor). Each role has different legal responsibilities, and liabilities, and rights. These responsibilities and liabilities become evident and may cause conflict if the borrower defaults.

The purpose of this section is to define and compare the roles of the various cosigners including legal rights and liabilities. This information will help persons asked to cosign loans or notes to better understand exactly what legal obligations consigners assume. This material should also help borrowers to better understand the level of legal liability for a cosigner, the desirability of cosigners to lenders, and some of the reasons why parents, other relatives, and friends may hesitate to assume such a role.

COSIGNERS

A cosigner is a person who signs a document or an instrument along with another, often assuming obligations and providing credit support to be shared with other signers.1 This does not always mean that a cosigner assumes the same liabilities that the borrower assumes.

COMAKERS

A cosigner who signs with the borrower as a maker of a note is a comaker. By practice, if a person signs an instrument in the lower right-hand corner, the law regards that person as a maker.2 The comaker is bound by the same contract terms as the borrower (principal debtor) who agrees that he/she will pay the obligation according to the instrument's terms at the time of signing.3 The comaker of a

note is primarily liable on the note.4 The lender can collect payment from either party. Each comaker agrees with the other to pay the debt and their relation to each other is that of a surety; but to the lender, both comakers are prinicpal debtors. Because both parties are considered debtors, a comaker who makes full payment is entitled to receive only a contribution from the other comaker instead of reimbursement for the entire amount paid. The comakers each legally owe one-half of the loan (but the lender can collect the entire amount from one comaker).

If a father is a comaker on a promissory note with his son and the son gives property that he alone owns as security for the loan, the note and not the names on the collateral title determines the liability. Even though the father's name does not appear on the title, the father is still primarily liable on the note he cosigns. If the son defaults on the note, the lender can collect payment from the father or the son, but the father can legally get reimbursement from his son for only one-half the amount paid.

However, if one comaker gives property as security for a note and later defaults, the lender is required to notify the other comaker of any intended disposition of the property if the lender expects the comaker to satisfy any deficiency.5 If the lender fails to give the comaker the required notice, the lender cannot collect the deficiency from the comaker.

Suppose a son gives a lender a lien on farm machinery as security for a promissory note in the amount of $100,000 on which the father and son are comakers. The son later defaults on the loan, surrenders the farm machinery to the lender, and the lender sells the farm machinery without giving the father notice. The lender sells the farm machinery for $80,000. This leaves a $20,000 deficiency between the amount received on the sale and the amount owed on the note. Because the lender is required by statute6 to give the father (comaker) notice of the sale and did not, the lender cannot collect the $20,000 still owed on the note from the father.

ACCOMMODATION PARTY

The Ohio Revised Code indicates that any person who signs an instrument in any capacity for the purpose of lending their name to another party to the instrument is an accommodation party.7 By definition then, a cosigner is an accommodation party.

SURETY

An accommodation party is a surety. A surety agrees to see that the lender does not take a loss if the borrower becomes unable to repay the loan. The surety does not receive any of the money the borrower receives on the note. A father who signs a promissory note to help his son (a farmer) get a production loan does not get any of

the money himself. The father is an accommodation party and a surety on his son's note. If the son is unable to pay the note when due, the lender will expect the father (surety) to see that payment is made.

The unpaid surety who signs strictly to accommodate a borrower is favored in law and the terms of the suretyship are to be strictly construed.8 (Professional sureties who receive pay to act as sureties; i.e., such as insurance companies, are not discussed.) Any change in the original agreement between the lender and borrower without the consent of the surety will release the surety from further liability.9 If the creditor and the son in the above example get together and agree that the promissory note will be for a higher amount than originally discussed or the maturity date is extended, the father is no longer liable unless the father consents to be a surety for the new amount or the extended maturity.

Sureties have special statutory and common law rights. A surety is entitled to full reimbursement from the borrower of any money paid to a lender on behalf of the borrower. The Ohio Revised Code specifically gives the surety the right to sue the borrower for reimbursement.10 If the loan or note becomes due and is not paid, the surety may choose not to pay himself but to bring an action directly against the borrower to make payment.11

The surety may also require the lender to sue the borrower before collecting from him/herself.12 The surety must give the lender notice in writing to begin an action on the instrument against the borrower. If the lender fails to begin an action within a reasonable time and does not proceed to try to collect from the borrower using due diligence, the lender forfeits the right to collect from the surety.

ACCOMMODATION MAKER

An accommodation party who signs a note as a maker is an accommodation maker and is primarily liable on the loan instrument.13 A cosigner will be held legally liable as a maker as the note is signed as a maker regardless of the fact the creditor knew the cosigner was an accommodation party.14 If the principal debtor defaults, the creditor may collect payment from either the borrower or the accommodation maker.

Although the accommodation maker has the same liability to the lender as a comaker, the accommodation maker is a surety and is entitled to the statutory and common law suretyship rights already discussed, in addition to the right of a maker. The accommodation maker differs from other sureties because the lender can collect from the accommodation maker directly without trying to collect from the principal debtor first. As a surety, the accommodation maker is legally entitled to

total reimbursement of any amount paid on behalf of the principal debtor, while ordinary comakers can only get a fair-share contribution from a comaker.

By statute, the accommodation maker (as a surety) may be relieved of liability for payment of a loan to the extent the creditor, without the accommodation maker's consent, unjustifiably impairs any collateral given to the lender for the loan (whether given by the accommodation party or the principal debtor).15

It is often difficult to determine whether a cosigner intended to be an accommodation party or a comaker on a note or loan. Because the cosigner's status determines legal liability, that status is often an area of conflict between cosigner and lender. The Ohio Court of Appeals has indicated that the question of whether a cosigner was an accommodation party is a matter of fact to be determined from the circumstances at the time of signing. Information which should be considered to help determine the status of a maker include: (1) the location of the signature on the note; (2) the language of the note itself; (3) whether the comaker received any of the loan proceeds; and (4) the intent of the parties when the note was signed.16

Cosigners can avoid conflict if they make sure the note or loan instrument specifically states that the cosigner is a surety. A more definitely worded loan instrument can eliminate the problem of a cosigner being presumed by law to be a maker when the cosigner signs in the lower right corner. Another way to help avoid conflict as to whether a cosigner is an accommodation party only or a maker is for the cosigner to sign "John Doe, Surety". A written indication that a cosigner meant to sign as a surety at the time the loan or note was made provides the most accurate record of the intent of the parties.

GUARANTORS

A guarantor is a person who promises to answer for the debt or default of a third person. In Ohio, a guarantor of a note is also considered a surety17 and is entitled to all the statutory and common law rights discussed under surety. The contract the guarantor makes to insure payment is referred to as a guaranty and is separate and distinct from the contract of the principal debtor. The principal debtor is not a party to the guaranty and the guarantor is not a party to the principal obligation.

A contract of guaranty, like any other contract, is unenforceable without consideration. Consideration is a bargained-for exchange which benefits one party or is of detriment to the other party. A guarantor gives a creditor consideration when the guarantor agrees to pay if the principal debtor

cannot pay. A creditor gives consideration when the creditor agrees not to exercise the right to sue the principal debtor or agrees to extend or defer payments on the principal debtor's loan.

The guarantor's contract with the creditor is also separate and distinct from the principal debtor's contract with the creditor; the guarantor's contract with the creditor is also secondary to the principal debtor's contract. The principal debtor is always primarily liable on the contract which means the creditor must try to collect from the principal debtor first. The guarantor is liable only if the principal debtor cannot pay.18 The guarantor can be sued jointly with the principal debtor19 unless the guaranty has a condition that requires the creditor to proceed and receive judgment against the principal debtor first.

Since the guarantor is also a surety, the guarantor has the right to be reimbursed for any amount paid on behalf of the borrower. However, if the guarantor, by agreement or by action, waives the right to assert an available defense to payment, the guarantor cannot collect payment from the principal debtor.20 Suppose a son refuses to make a requested final loan payment because he has already made payment. The creditor requests payment from the son's father, a guarantor on his son's loan, who makes the payment. Through his actions, the father has waived the son's right to withhold payment. The father would not legally be able to enforce reimbursement by his son.

Types of Guarantors

The liability of the guarantor is always conditioned upon the failure of the principal debtor to perform; therefore, defenses available to the principal debtor are also available to the guarantor. It is important to distinguish exactly what type of guaranty is being given because the extent of liability of a guarantor is closely related to the classification of the guaranty: absolute or conditional, limited, or unlimited.

(1) General or Absolute Guarantor -- The general or absolute guarantor guarantees payment to the creditor on the same terms as the principal debtor if the principal debtor cannot pay.21 The liability of the guarantor is not dependent on any conditions expressed or implied in the guaranty contract. In an absolute guaranty, the guarantor becomes liable where the account is not paid in a reasonable time after it becomes due or payable. If a contract of guaranty for a note or loan is absolute or unconditional, the guarantor is not entitled to a demand for payment and a notice of default before being held liable upon the guaranty.22 The creditor can also demand payment from an absolute guarantor before the creditor resorts to any security.

By statute, any words that indicate a guaranty but do not state specific conditions are to be interpreted to mean the guarantor will make payment.23 The liabilities and rights of this type of guarantor are similar to the accommodation maker. As with other sureties, the guarantor is released from liability if the contract is altered without the guarantor's consent. One Ohio court held, however, that where payment of credit becomes delinquent, an unsubstantial extension of time and change in manner of payment, which is not a material alteration of the specified terms of credit but is merely a method of correcting an amount past due, does not discharge the guarantor who had knowledge of the extension and change.24

(2) Conditional or Limited Guarantor -- Liability of a conditional guarantor is not triggered when the principal debtor defaults. All conditions set out in the guaranty contract must be met by the creditor before the guarantor is liable for payment.

The guarantor may guarantee collection instead of payment. To fix the liability of a guarantor under a guaranty of collectibility, the creditor must prosecute the principal debtor to judgment and receive no property25 and the creditor must give the guarantor notice of the default.

A guarantor can also limit liability in several ways. A guaranty may be continuing (unlimited time) with the guarantor bound for future credits but limited as to amount. A guaranty may be limited as to time and amount or limited for just the amount.

SUMMARY

Given the above information, it is easy to understand why creditors desire cosigners. Basically, the creditor wants to reduce the risk of loaning money by providing alternative means of collecting if the principal borrower defaults. Any cosigner will reduce the creditor's risk but cosigners that can be required without the cost or time of litigation are the most attractive (i.e.. absolute guarantor, comaker, and accommodation maker). If a borrower is required to have a cosigner on a loan or note the absolute guarantor, comaker, or accomodation maker will provide the best bargaining ability for the borrower. It is important that both the borrower and cosigner be aware of the liabilities, responsibilities, and rights of each type of cosigner. Cosigner parents, especially, should consider that the legal right of reimbursement from a principal debtor may not mean very much if the principal debtor is a child and the parent does not want to exercise that right. Without the real possibility of being reimbursed by the prinicipal debtor, even an accommodation party may ultimately be accepting total liability if

the principal debtor defaults.

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1. Black's Law Dictionary, Abridged 5th Ed. (St. Paul, MN: West Publishing Co., 1983).

2. Huron County Banking Company v. Knallay, 22 Ohio App. 3d 110, 489 N.E. 2d 1049 (1984).

3. O.R.C. 1303.49(A) and U.C.C. 3-413.

4. O.R.C. 1303.51(B) and U.C.C. 3-415(2).

5. Miami Valley Production Credit Association v. Hastings, No. 84 CA 89 (Ohio Ct. App., 2d Dist., 1986).

6. O.R.C. 1309.47(C) and U.C.C. 9-504 and O.R.C. 1317.16 and 48 O Jur 2d Sections 264 and 273.

7. O.R.C. 1303.51(A) and U.C.C. 3-415(1).

8. Whaley, Douglas J., PROBLEMS AND MATERIALS ON NEGOTIABLE INSTRUMENTS (Boston: Little, Brown, and Co., 1981), p. 102.

9. O.R.C. 1303.43; The Federal Land Bank of Louisville v. Taggart, No. CA-3174 (1986 Ohio Ct. App., 5th Dist., June 23, 1986), slip opinion; U.C.C. 3-407.

10. O.R.C. 1303.51(E) and U.C.C. 3-415(5).

11. O.R.C. 1341.19.

12. O.R.C. 1341.04.

13. Bank One of Northeastern Ohio, N.A. v. Musser, 8 Ohio Misc. 2d 19, 456 N.E. 2d 844 (1983).

14. O.R.C. 1303.51(B) and U.C.C. 3-415(2).

15. O.R.C. 1303.72(A)(2) and U.C.C. 3-606(1)(b).

16. Huron County Banking Company v. Knallay, 22 Ohio App. 3d 110, 489 N.E. 2d 1049 (1984).

17. O.R.C. 1301.01(NN).

18. Bratenahl Development Corp. v. Hunkin-Conkey Constr. Co., 52 Ohio Op. 2d 15, 255 N.E. 2d 578 (1970).

19. Ohio Rules of Civil Procedure, C.R. 20(A).

20. Mutual Finance Co. v. Politzer, 21 Ohio St. 2d 177, 256 N.E. 2d 606 (1970).20.

21. O.R.C. 1303.52(A) and U.C.C. 3-416(1).

22. O.R.C. 1303.52(E) and U.C.C. 3-416(5); Northern Ohio Tractor, Inc. v. Richardson, 8 Ohio App. 3d 171, 456 N.E. 2d 824 (1982).

23. O.R.C. 1303.52(C) and U.C.C. 3-416(3).

24. Burnside Steel Foundry Co. v. General Metal Products Corp., 115 Ohio App. 121, 184 N.E. 2d 469 (1961).

25. O.R.C. 1303.52(B) and U.C.C. 3-416(2).

DEBTOR RESPONSES TO FINANCIAL STRESS

Financial stress calls for prompt and positive action by debtors. This is a searching process to determine what may be the best farm plan and the best financial plan. Budgeting and exploring alternatives is an important part of this process. Once the alternatives have been explored and the most feasible alternative has been budgeted in some detail, creditors should be contacted. Farm creditors for the most part have been very willing to adjust credit terms to assist farmers if there are reasonable prospects for financial survival.

Debtors need to understand and work within the constraints and security status of the various creditors. Unsecured creditors frequently have few options available. One fact of the farm credit picture is that there are often few if any unencumbered assets. An unsecured creditor who becomes aggressive in collection could lead to a liquidation of a farm with the secured creditors obtaining most if not all of the assets.

The process of exploring the alternatives and arriving at a satisfactory plan requires communication, negotiation, and compromise. All creditors should be kept informed. It is sometimes wise to have a general meeting of all the creditors to the business.

Several different adjustments have been made by various farm businesses experiencing financial stress. Not all of the possible options are available for any one business. The following list of financial restructuring options will help in this exploration process.

REFINANCE

If there is enough equity left in real estate and other capital assets such as machinery and breeding livestock, it may be possible to move some short term debt to intermediate and long term debt. Short term debt is certainly the most demanding on cash flow. The current cash flow requirements can be reduced if the short term debt can be amortized over longer periods. It may also be possible to move some intermediate term debt to a long term schedule.

Creditors will typically require additional security before they will stretch out loan repayment schedules. Be prepared, for example, to consider first or second mortgages on real estate to secure nonreal estate loans.

Another aspect of refinancing is the concept of consolidating the debt. More favorable terms can sometimes be obtained if the debt is in the hands of fewer creditors. Consolidation may also be a way of reducing the number of collection contacts being experienced as well as achieving a better match between loan repayment schedules and

the farm business cash flow.

INTEREST RATE REDUCTION

Some farmers have been able to negotiate an interest rate reduction. Interest rates in general have declined from the very high levels of the early eighties, thus some lenders will renegotiate rates on loans made under those high interest rates. Also, government programs such as the FmHA buy down plan and the Ohio Linked Deposit program can be used in some cases to reduce interest rates.

Borrowers need to understand the very logical concept that higher risk loans should be paying more interest. This concept generally works against the feasibility of negotiating lower interest rates for financially stressed operations. Some lenders have implemented differential loan pricing programs that offer lower rates to low risk borrowers. In some cases, it may be possible to improve ones "risk rating" by offering additional security.

WRITEDOWN OR FORGIVENESS OF DEBT

Some farm borrowers have been able to negotiate a writedown of part of the outstanding principal on their debts. This can provide a significant improvement in the cash flow.

Creditors will be more willing to consider a writedown if the current fair market value of the assets is considerably below the amount of the loan. In this situation, creditors would often rather negotiate a writedown outside of bankruptcy than to have a forced writedown within bankruptcy. A negotiated writedown is less costly and less time consuming, and if a liquidation does occur, the creditors would receive only the current fair market value anyway. Like refinancing and interest rate reductions, achieving a writedown is likely to involve granting additional security.

SELL CERTAIN ASSETS

Another option to consider is to sell some assets. The proceeds from the sale can be used to reduce the principal outstanding and thereby reduce the loan payments. Assets such as parcels of less productive land, unneeded items of equipment, and livestock which are less productive are prime candidates for sale.

The sale of less productive assets will generally have little impact on the profitability of the business. If it is necessary to sell assets that are essential for continued operation, arrangements for control of these assets must be made. Examples include leasing back from the buyer or custom hiring.

Although selling assets may help resolve financial problems, there are a number of potentially negative tax impacts. These are described in a subsequent section of this handbook. Be certain that these tax impacts are fully understood before selling assets.

RENEGOTIATE COLLATERAL POSITIONS

Creditors are understandably concerned about their security positions when the debtor is financially stressed. Nevertheless it is sometimes possible to negotiate changes in the collateral status of the various creditors.

One option is to obtain releases of valueless liens. Some creditors have junior liens such as second or third mortgages that are worthless because the market value of the collateral has declined to the point where it is now less than the amounts owed to prior creditors. Often, the simplest solution for the creditors holding valueless liens is to release the debtor from the obligation.

A common dilemma in financially stressed operations is satisfying the collateral demands of landlords and suppliers who are furnishing operating inputs. In this case, it may be possible for a creditor to agree to subordinate their position in certain collateral. It may even be possible to achieve a complete release of certain collateral from a creditor allowing that collateral to be pledged to another one. This works best if the creditor being asked to subordinate a release is in an overly secured position.

Even if principal creditors are unwilling to subordinate their positions or to release collateral, they may be willing to guarantee payments to input suppliers and landlords. The debtor, the principal creditor and input supplier or landlord should all be partners to a payment guarantee agreement.

The Farmers Home Administration loan guarantee program is another possibility for improving the creditor's security position. Under this program, the commercial lender extends the loan and FmHA guarantees that if the debtor defaults, the creditor will bear no more than 10 percent of any losses. Under current and proposed federal budgets, an increasing share of FmHA lending falls under the guaranteed loan programs. The "approved lender" program has addressed some of the problems of processing loan applications; however, FmHA is experiencing very serious loan delinquency problems. Thus, new applicants should anticipate a very thorough examination of their applications. Be prepared to provide extensive documentation of cash flow feasibility.

COSIGNERS

A cosigner on the note is another common method for enhancing the security position of the lender. Having a cosigner on the note may make it possible to negotiate better terms such as a lower interest rate and/or a longer repayment period.

In most cases, the cosigner will be a relative or friend who is interested in seeing a person stay in business. A cosigner is liable

for repayment if the borrower defaults, so all of the concerns of cosigners discussed in detail in another section of this handbook need to be evaluated. Both the debtor and the cosigner should be convinced that the business is going to survive. There are many instances where otherwise financially secure parents have lost everything because they cosigned on notes with their children.

NONACCRUAL OF INTEREST

A rather common practice on the part of examiners is to require creditors to place seriously delinquent loans in a nonaccural status. When this happens, the payments go toward principal, not interest. It may also mean that as long as these principal payments are made, foreclosure will not be initiated. Some debtors have had uncertainties about the nonaccural of interest status. Questions include: Will that interest not being currently paid have to be paid someday? How long can the nonaccural status continue? What are the tax implications of having payments applied on principal instead of interest? Payments on principal are not tax deductible while payments on interest are. These and other questions should be resolved with the creditor.

INTEREST ONLY PAYMENTS

Some delinquent borrowers have been able to negotiate a completely opposite agreement-interest only payments for a period. During that period, the principal would not decrease and all payments go toward interest. Thus they can continue to be treated as a tax deductible expense.

HELP FROM FRIENDS OR FAMILY MEMBERS

In addition to cosigning notes, there are other ways in which friends, family members or others can assist a financially troubled operator. Sometimes a friend or family member may be willing to offer a loan. Normally these kinds of loans in a financial stress situation are unsecured and therefore would not be paid in case of liquidation. Where possible, it is preferable to offer collateral on loans from friends or relatives so that full or partial recovery is more likely if liquidation occurs.

GIFTS

Sometimes friends and family members are willing to make gifts to help a person facing financial stress. This might be gifts by way of a specific sum of money, a reduction of the rent charged on the land, a reduction in interest or principal on loans, or a willingness to pay certain items of the debtors's expenses. Here too, the consequences of a liquidation should be considered. If the business is liquidated, the proceeds of any gifts may well end up going to the creditors. In otherwords, it is sometimes better to delay transfer of gifts until after a bankruptcy is concluded.

A family inheritance can be viewed in much the same

way as gifts. It is possible that an inheritance would cause the financial picture to improve enough to continue in busi- ness. However, if the business cannot be saved anyway, an inheritance might end up going to the creditors. For this reason, some farmers have asked parents not to bequeath assets to them if there is no possibility for business success.

FRIENDLY BUYER

If assets are to be foreclosed on by a creditor, possibly a family member or other friendly buyer can be of help. The creditor could be paid for the current value of the collateral, the friendly buyer would then own the assets and possibly a lease or employment arrangement can be worked out between the new owner and the debtor. This arrangement might work for land, machinery, or breeding livestock. Again, be alert for adverse tax consequences when selling assets.

DEED IN LIEU

A rather common alternative that is being used during this period of financial stress is the possibility of transferring collateral to the secured creditor in lieu of a foreclosure action. This has most typically been done with farm real estate and in some cases farm machinery. When a deed in lieu is negotiated the creditor takes the asset and any debt exceeding the fair market value of the asset is written off.

Sometimes an arrangement to transfer assets in lieu of a foreclosure action incorporates favorable provisions for the debtor. One gives the debtor the absolute right of repurchase for a period of time or a right of first refusal in case the creditor undertakes a sale of the asset. Also debtors are sometimes able to negotiate the possibility of leasing the asset back from the creditor. This is more common with farm land, the debtor arranges for the right to lease the farm land for a period of time. As this alternative is considered the tax consequences of a deed in lieu will need to be analyzed in addition to the other considerations involved.

1985 FARM BILL-FmHA

The 1985 Farm Bill contains two special provisions relating to Farmers Home Administration foreclosure actions. The Homestead Retention provision offers a possibility for the debtor to retain possession of the residence and up to five acres for a period of up to five years. The law also provides the opportunity to repurchase the homestead during the five year period. The 1985 Farm Bill also provided for the possibility that the debtor could lease back land turned over the FmHA. FmHA borrowers who become involved in a foreclosure or deed in lieu should inquire about their eligibility for these special options.

CROP SHARE RENTAL

Cash rent landlords may be reluctant to rent land to

financially stressed tenant operators for the next year. It may be possible to switch to crop share rental so the landlord owns a portion of the crop and would not be considered a creditor. Since crop share landlords typically buy some of the inputs, the need to operating funds is also reduced for the operation --an added boost for a financially stressed farmer.

DELAY IN LIQUIDATION

Sometimes it is possible to delay a liquidation for a time period. A major reason for doing this would be tax planning. It could be with some budgeting that it is learned that high taxes would be incurred upon liquidation of several assets at one time. Thus negotiating a deferral of the liquidation of some assets to a later tax year could be of mutual benefit to both debtor and creditor.

BANKRUPTCY

For farmers experiencing financial difficulty, bankruptcy is an option to be explored as well. Usually counselors like to review all of the other options which may be available prior to making the election of bankruptcy. Once a bankruptcy election is made the lines are drawn and exploring for alternatives outside of court supervision are more difficult. A detailed discussion of bankruptcy follows in a later section of this handbook.

SUMMARY

As financial difficulties are faced, the options for dealing with these problems need to be explored in detail. As that exploration takes place, communication with all creditors is important. All creditors should be kept fully aware of the deliberations and the feasibility of any alternatives. It is possible that loan contracts now in place can be amended. Any amendments certainly need to be put in writing. Whenever alternatives are explored the tax concerns of those alternatives need to be analyzed as well.

CREDITOR COLLECTION RIGHTS

COLLECTION PROCESS, PAYMENT DEMAND

Proper demand for payment is considered a general prerequisite to begin the collection process, and is an important prelitigation consideration. It is usually the goal of the creditor to have the debtor continue to make payments on the obligation. A letter declaring that a default has occurred and demanding the account be brought up to date within a set time period may be all the action that is needed. A demand letter of a more serious nature may declare a default and notify the debtor of acceleration of the entire outstanding balance, with payment due in full within a defined time period.

Since acceleration is a contractual remedy, it can not be used unless an acceleration clause is present in the note. If acceleration has occurred the creditor must "be wary of accepting partial payments which may afford the debtor with waiver or estoppel defenses, or constitute accord and satisfaction".1 In the case of First National Bank & Trusts Co. v. Fireproof Warehouse & Storage, 8 Ohio App. 253 (Franklin Cty. 1983) the court held that the creditor must either accept the amount tendered upon the terms of the tender or reject it entirely. A creditor cannot avoid an accord and satisfaction by cashing a check that is tendered as payment in full of a disputed claim and thereafter advise the debtor that he still intends to collect the full amount.2

PRELITIGATION REMEDIES AVAILABLE TO THE SECURED CREDITOR

Statutory remedies available to the secured creditor are found within O.R.C. Chapter 1309 or U.C.C. Chapter 9 or as provided in the security agreement.

Voluntary Turnover of Collateral

It may be possible that a debtor would voluntarily release the collateral. The debtor and creditor agree to terms where all or a portion of the obligation of the debtor will be satisfied, as stated in a negoitated formal turnover letter. Such a letter would include the terms of the agreement and the procedural outline for inventory and appraisal of returned collateral and credit to the debt.

Self-Help Repossession

Unless an agreement was made to the contrary, a secured creditor has the right to take possession of the collateral, if he can do so without a "breach of the peace".3 If it cannot be accomplished without a "breach of the peace" then replevin action and the exercising of statutory and/or contractual rights can be implemented.

Disposal of Collateral Resulting from Self-Help Repossession or Replevin

The secured creditor can dispose of repossessed

collateral through either a public or private sale.4 However, for retail installment sales of consumer goods disposal is limited to a public sale unless there is a judically approved waiver by the debtor.5

When collateral is disposed of the method, manner, time, place, terms, and all other aspects must be commercially reasonable.6 Reasonableness is not soley determined by price; it includes whether collateral is sold in the usual recognized market or conforming with the business practices among dealers of that type of product. If the requirements of commercial reasonableness are not met, a presumption is created that the value of collateral and the secured indebtedness are equal and the debt is considered cleared. This holds unless the secured party is able to rebut the presumption.7 The burden of proof is on the creditor to show that the sale of the collateral was accomplished in a commercially reasonable manner.8

Notice of the sale must be given to the debtor and appropriate publicity provided through publication in local newspapers, notification given to dealers, etc.

Under certain circumstances the creditor may retain the collateral in lieu of a sale and consider the debt fully satisfied.9 Written notice of this proposal must be served upon the debtor and he has 21 days to object and force a sale.10 This procedure cannot be utilized if the collateral is consumer goods where "the debtor has paid sixty percent of the cash price in the case of a purchase money security interest, or sixty percent of the loan amount".11

Deed in Lieu of Foreclosure

In certain situations it may be appropriate for the two parties to discuss the possibility of avoiding a law suit by giving the creditor a deed in lieu of foreclosure. This would transfer to the mortgage or lien holder all of the debtor's interest in the property, usually releasing all of the debtor's obligations to the creditor.

LITIGATION

Should a decision be made to proceed with litigation the first steps include the analysis of the claims for relief and preparation of the complaint. A court must be selected, considering jurisdiction, and the debtor must be served with proper notification of the proceeding. Service can be accomplished by certified mail, personal service, ordinary mail, or publication.12

PREJUDGEMENT REMEDIES

Following the commencement of litigation, various remedies can be used to preserve, or protect property in question.

Replevin

In Ohio, replevin is now exclusively a right given to secured creditors through statutory authority and

procedure.13

Replevin is an action that may be brought by either the plaintiff or the defendant as a claim or counterclaim for return of personal property. The person bringing the action is called the "movant" and the person against whom the action is brought is the "respondent".

The action is initiated by filing a complaint including a claim for recovery of specific personal property. At the same time, or subsequently a written motion for an order of possession is also filed by the movant. "The motion must be served on the respondent.14 A support- ing affidavit must be attached to the motion, containing descriptions of the property and other required statements.15

A court date will be set within 20 days of the filing.16 A praecipe (an order issued from a court requiring performance of a specific act, or giving authority to have it done) must also be filed with the clerk to issue a notice of the proceedings to the respondent. The clerk then prepares a notice of proceedings for the respondent.

The notice tells that a claim for certain property has been filed and that the respondent has a right to a hearing upon request. It includes the time, date, and location of the hearing in case the respondent requests it; and that the respondent may retain possession of the property even without a hearing by filing a bond within five business days of receipt of the notice.17

If the respondent requests a hearing within five business days after receiving notice of the proceedings, a hearing must be scheduled by the court and notice must be provided to both parties. If as a result of the hearing the court does not find probable cause to support the motion of the movant, the property will be ordered back to the respondent without a bond requirement.

The court has the authority to issue an order of possession to the movant without the hearing if the following hold: (a) the notice, motion, and affidavit have been served on the respondent as required by the statute; (b) the respondent has not requested a hearing in a timely fashion and no continuance has been granted; (c) the respondent has not filed a bond; and (d) the court finds, on the basis of the affidavit, there is probable cause to support the motion.18

Probable cause to support the motion is defined as meaning that the movant will likely obtain judgment against the respondent which would allow the movant permanent possession of the personal property in question.19

If a hearing is held and probable cause is found on the basis of the affidavit or evidence at the hearing or if

there is no hearing because the respondent did not meet the tests set forth above, an order of possession will be issued by the court. The order of possession shall be addressed and delivered to the levying officer.

The order of possession must comply with those provisions set out in O.R.C. Section 2737.08. The order of possession does not go into effect until a bond is filed in favor of the respondent by the movant with the court. The bond amount will be an amount approximately twice the value of the property. The reason for the bond is if the judgment is for the respondent, the movant will need to return the property or pay the value of it and pay any damages resulting from the detention of the property, as well as the costs of the court action.20

Instead of the bond, the movant may deposit cash with the clerk of court. In certain circumstances the bond may be waived entirely or reduced in amount.

If the court finds probable cause on the basis of the motion, affidavit, and other evidence that the movant will suffer irreparable harm if there is a delay in the order until the holding of a hearing, an order of possession may be issued by the court ex parte; a court proceeding, order, etc. taken or granted at the instance and for the benefit of one party only, and without notice or opportunity for a hearing by to any party adversely interested.

Irreparable injury can be found by the court only: (a) where there is present danger that the property will be immediately disposed of, concealed, or placed beyond the jurisdiction of the court; or (b) where the value of the property will be impaired substantially if the issuance of an order of possession is delayed.21

If the movant does obtain possession of the property and then fails to prosecute the action to final judgment, the court may order the movant to return the property to the respondent, and pay damages for deprivation of property, upon the respondent's request.22

Attachment Before Judgment

Attachment (a judicial order to seize property in order to secure a creditor's claim or debt when a judgment is rendered) is another purely statutory prejudgment remedy available to the creditor. It is a remedy set up to preserve the property of the defendant so it is available to satisfy the judgment the plaintiff is able to obtain. Attachment is only available when there is reason to believe that without it judgment satisfaction will be difficult or impossible. It is always used as an aid to fulfillment of another action, never as a remedy by itself, and is available for recovery of money.23 It is not usable in actions in small claims divisions of municipal or county courts. One major

limitation to it is that wages or earnings are not attachable in prejudgment remedies.24

Grounds for attachment are limited to those specified with the burden of proof lying with the creditor, or movant. Only one of the grounds need be proven for attachment to be usable. Those grounds, as specified by statute are: (A) When a debtor has sold, conveyed, or otherwise disposed of his property with the fraudulent intent to cheat or defraud his creditors, or to hinder or delay them in the collection of their debts, (B) When a debtor is about to make such sale, conveyance, or disposition of his property, with such fraudulent intent, (C) When a debtor is about to remove his property, or a material part thereof, with the intent or to the effect of cheating or defrauding his creditors, or of hindering or delaying them in the collection of their debts.25

The steps of the procedure begin with a complaint being issued seeking the recovery of money, and possibly including a prayer for order of attachment among other claims set forth. At the same time the plaintiff files a written motion for an order of attachment of property other than that of personal earnings.26 Local rules frequently require supporting memoranda to accompany all motions for relief. However, the memoranda may be fulfilled by an affidavit which is required by statute to be attached to the motion.27

The affidavit must include the following: (1) nature and amount of the plaintiff's claim; (2) facts supporting at least one of the grounds for the order found in O.R.C. Section 2715.01; (3) description of the property and approximate value; (4) location of the property; (5) to the best of the plaintiff's knowledge, the present use of the property by the defendant and that the property is not exempt from attachment or execution; and (6) the name of the third party possessor of the property, if applicable.28

"The motion and affidavit must be served upon the attorney of record, if any, for each party to the proceeding.29 The motion must be filed with the court within three days of service and must contain a certificate of service."30

The plaintiff is also required to file a praecipe with the clerk of courts directing the clerk to issue to the defendant the notice of proceedings, a copy of the motion and affidavit, and a hearing request form.31 The notice of proceedings explains to the defendant that an order of attachment has been applied for on certain property; that the defendant has the right to a hearing, if requested; and gives the specific time, date, and location of the hearing if it is requested. It also states that the property can be held by the defendant if a specified bond is filed within five business days of recovering notice. This notice is

normally prepared by the clerk's office, however, it will not be issued automatically to the defendant. It is the duty of the plaintiff to notify the clerk when the notice is to be issued.32

The clerk also needs to have prepared a hearing request form which is delivered to the defendant along with a postage paid, self-addressed envelope or postcard.

The service to the defendant of all required notices and forms33 must be accomplished within seven business days prior to the hearing date, and the hearing date must be within twenty days of the filing of the motion.

The defendant, in response, may request a hearing within five business days. Having failed to do so, he may request a continuance prior to the hearing if justification can be given for failure to request the hearing.34

Filing of a bond by the defendant would prevent prejudgment attachment, or allow the regaining of possession if the property has already been taken. The bond would likely equal the amount filed by the plaintiff.35 If no objection has been filed within ten days of the filing of the bond, all objections to the amount set are waived.36

In the event of no request for a hearing by the defendant, the court will issue an order of attachment where it finds that: (1) the notice, motion, and affidavit have been served on the respondent as required by the statute; (2) the respondent has not requested a hearing in a timely fashion; (3) the respondent has not filed a bond; (4) the court finds, on the basis of the affidavit, that there is probable cause to support the motion; and (5) not continuance has been filed or granted.37

If there is a request for a hearing only two issues are allowed to be considered, "(1) probable cause to support the motion and (2) whether the defendant's property is exempt".38

In order for the attachment to be effective the plaintiff must file a bond of an amount approximately twice the value of the property. The reasoning being, to cover payment for the property and damages suffered by the defendant if judgment goes against the plaintiff.39

Prejudgment Garnishment

Garnishment (a collection remedy whereby a third party has property of the debtor or owes a debt to the debtor and these are applied to the payment of a judgment against the principal debtor) is frequently considered a form of attachment, and many of the procedures and prerequisites of the prejudgment attachment are the same for prejudgment garnishment (a notice to a third party that the creditor claims a right in the property or debt owed of the debtor and that the third party should

hold the property or debt until a judgment has been rendered).40 Differences between attachment and garnishment are described below.

An affidavit must accompany the motion as it does with a motion for an order of attachment. It must include a statement that there is good reason to believe and the plaintiff does, in fact, believe that a third party has possession of the property of concern.

The steps and procedure from the filing of the complaint to the issuing of the order are the same as for attachment. With an attempt to collect the property and inability to do so (because the third party refuses to give up possession, or the officer is unable to locate the property) the special garnishment procedure is intitiated.41 The controlling statutes and rules provide specific methods for service of the attachment order and notice to be used where the garnishee is an individual, partnership, or corporation.

Injunctive Relief

In addition to, or in place of other forms of relief, the creditor may be able to use a temporary restraining order, preliminary injunction, or permanent injunction.42

Injunctive relief may be helpful in collection cases where there is a threat that the debtor will dispose of assets prior to trial, or prior to the time attachment or replevin can be effected.

Every restraining order and order granting an injuction must set out the reasons for its issuance, and a description, in reasonable detail, of the act or acts sought to be restrained. The order shall be binding upon the parties to the action, their officers, agents, servants, employees, attorneys, and those persons in active concert or participation with them who receive actual notice of the order whether by personal service or otherwise.43

Receivership

This is a prejudgment and post-judgment collection remedy where a third party with no interest in the property or action is appointed by the court to administer, care for, collect, and dispose of property (or its produce), of another brought under the orders of the court by litigation.44 Courts tend to be very reluctant to place property under a receivership as a prejudgment remedy, since it is seen as a harsh procedure.

The last twenty years have seen prejudgment remedies under attack by the courts and legislature. Especially those prejudgment remedies related to wages and consumer transactions.

"In Sniadach v. Family Finance Corp., 395 U.S. 337 (1969) the court held that the Wisconsin statute providing

for prejudgment garnishment of wages was unconstitutional. Justice Douglas' opinion (in the case) emphasizes the hardship that results from wage garnishment and suggests that due process requires notice and hearing prior to the issuance of a writ, except in 'extraordinary situations'."

"Fuentes v. Shevin, 407 U.S. 67 (1972), expands the due process limitations first recognized in Sniadach to property other than wages, to prejudgment remedies other than garnishment. Fuentes involved replevin of consumer goods."

"The following basic propositions seem clear: (1) prejudgment remedies are not unconstitutional per se; (2) the use of prejudgment remedies is subject to due process limitations; (3) due process requires notice and an opportunity for an adversary proceeding; and (4) in at least some situations, a pre-seizure ex parte hearing coupled with the opportunity for a prompt post-seizure adversary proceeding will satisfy due process."45

OBTAINING JUDGMENT

A proceeding for a court judgment on a lien is initiated by the creditor filing a complaint with the court. The debtor has twenty-eight days to answer the complaint.46

Default Judgment

If there is no plead or other defense by the defendent, the creditor/plaintiff may apply for judgment by default either orally or in written form. (Default judgment means the defendent did not answer the complaint which was filed.)

If a default has occured a motion may be filed for default judgment, and entry for judgment submitted to the court. If the defendant has not made an appearance up to that time no prior notice is necessary. If an appearance has been made then a written notice of application for judgment must be served at least seven days before the hearing.47 "Most collection actions result in default judgment for the creditor."48

Cognovit Judgment

Many notes binding creditor/debtor agreements have a cognovit provision. Not all states allow this type of note. The parties agree at the time of the signing of the note that if the debtor defaults on the obligations, the creditor has the right to obtain a judgment against the debtor without notification and without a hearing.49

In a case such as this, an attorney, selected by the creditor, appears in court to confess judgment against the debtor for unpaid debt, fees, and charges, all without service of process on the debtor. The debtor may not even know that a judgment has been entered. A cognovit judgment can only be obtained if a cognovit note was executed. In the note the "warning" language must appear more clearly and conspicuously

than any other type50 and it must appear either above or below the area where the maker's signature is located. The entire procedure of obtaining a judgment can be completed in a matter of hours.

Judgment for a Reduced Amount

If the creditor is willing to accept a lesser amount than the original debt, but the debtor cannot pay the amount immediately, then it may be to the creditor's best interest to consider an agreed judgment entry where the debtor is given time to pay the reduced amount. However, should the debtor fail to pay the reduced amount in the time set, then he/she is obligated to pay the full amount.51

Attorney's Fees

"Generally attorney's fees cannot be recovered as a part of the costs in a judgment unless statutory provisions expressly permit such a recovery.52 The fact that the instrument evidencing a debt states that the creditor can recover its attorney's fees from the debtor does not alter this rule.53

Recovery of Costs and Interest

The general rules for recovery of court costs state that costs are recoverable "unless an expressed provision therefore is made in either a statute or the Rules of Civil Procedure or unless the court directs otherwise".54 A recovery for interest is generally permissible.55

POST-JUDGMENT COLLECTION REMEDIES

Determining Assets of Debtors

Following judgment it is necessary to determine those assets of the debtor that are not exempt. This can be done by an examination of the debtor and witnesses.56

One procedure is nonjudicial and can be accomplished through the use of nonlegal personnel, and will be much less costly. If the nonjudicial method proves to be ineffective there are two methods which allow the creditor to subpoena the debtor or witnesses to testify.57

"These provisions allow the judgment creditor to require the debtor to answer interrogatories, to be subpoenaed, or to appear at a deposition at the attorney's office if the debtor resides, is employed, or transacts business in the county where the office is located.58

A deposition may be taken by other than stenographic means,59 such as by tape recording. Also depositions may be taken before a person authorized to administer any oaths, such as a notary public.60 Thus, in order to reduce collection costs, the deposition can be taken before a notary public and tape recorded if the notice or subpoena provides that the testimony will be tape recorded."61

If the court feels there are grounds upon which an

order of attachment may be issued, it may order such attachment to be made before issuance and return of execution.62 The court may also order money or property owed to the debtor to be used in satisfying the judgment if it is nonexempt.63

Appointment of Receiver

The court may also appoint a suitable person as a receiver if a motion for such is made.64

Garnishment

An attachment on property, other than personal earnings, in the possession of another person can only be accomplished post-judgment through garnishment proceedings.65

The process is begun by the plaintiff's filing of an affidavit with the court rendering judgment. The garnishment proceedings are to be set for hearing within twelve days of the filing of the affidavit. The court is to notify the defendant of the garnishment and to send him hearing request forms. These must be served at least seven days before the hearing.66

The garnishee and defendant are both served with the notice and the defendant has the right to a hearing if he requests if within five business days of receiving the notice.67 If the defendant does not act within the five days, but has justifiable cause for not acting, he may request a continuance.

If a hearing is requested, the issues to be discussed are the amount of nonexempt property the garnishee has, besides wages, that can be used to satisfy the judgment.68 If the garnishee doesn't pay or deliver the money or property, though he admits having it, execution may be issued against him.69 If he fails to answer the notice a civil action may be filed against him by the plaintiff, and he may be held accountable for contempt of court.70

Wages exempt from garnishment include personal earnings in an amount equal to the greater of seventy-five percent of disposable earnings or Federal minimum hourly wage multiplied by a factor determined on how wages are paid: thirty if weekly; sixty if biweekly; sixty-five is semi-monthly; and one hundred thirty if monthly.71

An order of attachment in a garnishment action is subordinated to any [child] support order.72

For further information on garnishments see O.R.C. Chapter 2716.

Execution Against Debtor's Property

The process to enforce a judgment for the payment of money shall be a writ of execution, unless the court directs otherwise.73

Executions are available in three forms: (1) against the debtor's property, including orders of sale; (2) against the person of the

judgment debtor; and (3) for the delivery of the possession of real property.74

The procedure is governed by O.R.C. Chapter 2329 for both personal and real property.

Personal Property. For execution sales of personal property the sheriff or bailiff must advertise and conduct the sales. Advertisement should appear in all newspapers circulating in the county where the sale will be held at least ten days prior to the sale. The proceeds of the sale are subject to any existing property liens.

Generally the sales must be by public auction unless ordered otherwise by the court. And before the sale takes place the property must be appraised by three persons with no personal interest in the sale. Property must sell for at least two-thirds of the appraisal value, and must be sold by a licensed auctioneer or officer of the court.75

Real Property. There is a time constraint for real property of sixty days from the time of issuance to the time of sale. The property must be appraised by three disinterested parties from the same county where the land is located76, and the property must sell for not less than two-thirds of the appraised value unless there is a prior lien on the property in which case it can be sold for two-thirds the difference of the appraisal and prior lien value.77

If the property does not sell through lack of bidders at the first sale, then the property is reappraised.78 If it is still unsold following the second attempt to sell, the court has the right to direct the amount for which it should be sold.

The debtor may redeem the property at any time before confirmation (of the sale) by depositing with the clerk the amount of judgment upon which the property was sold, plus costs, and interest at the rate of eight percent per year from the date of sale.79 Many states have longer redemption times than Ohio.

Creditor's Bill

"When the nonexempt personal or real property of a judgment debtor is insufficient to satisfy the judgment, any equitable interest of the debtor in real estate, interests in a money contract, claim, or judgment, and other miscellaneous interests are subject to payment of the judgment. These interests may be reached by the filing of a complaint commonly referred to as a creditor's bill."80

SUMMARY

The rights and remedies available to the creditor in debt collection will be case specific depending on the type of creditor, secured vs. unsecured, and the situation and facts of the case.

It is suggested to begin the collection process through the determination of the debtor's status and the assets that are available to service

debts, as well as those assets which are exempt. A statement indicating that payment is due is an important prelitigation consideration; with the tenor of the statement based on the seriousness of the situation.

Prelitigation remedies available to the secured creditor include voluntary turnover of collateral; self-help repossession and disposal of the resulting collateral from it, or replevin; and deed in lieu of foreclosure. Should the case become a subject of litigation various options may be pursued, including replevin, attachment, garnishment, injunctive relief, or receivership.

Upon attaining judgment the creditor may use non-judicial methods, or examination of the debtor and witnesses through Ohio Civil Rule 69, to determine non-exempt assets available for servicing the debt. Enforcement of judgment may take the form of appointment of a receiver, garnishment proceedings, a writ of execution, or use of the creditor's bill.

Creditors generally will attempt to work through a default with a debtor if the debtor demonstrates goodwill and honesty in dealing with the institution.

Creditors and debtors should make themselves aware of the actions available to them and the repercussions facing them for their actions. This will allow them to make more efficient and proper use of legal counsel when and if it should become necessary.

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1. Bash, Brian; Johnson, Kenneth C.; Taps, Richard T., Ohio Collection Law, Professional Education Systems, Inc., 1984.

2. Ibid.

3. Morris v. First National Bank and Trust Co., 21 OS(2d) 25, 254 NE(2d) 683 (1970); Where a creditor legally enters upon the private premises of his debtor for the purpose of repossessing collateral security kept thereon and is (1) physically confronted by the one in charge of the business; (2) told to desist his efforts at repossession; and (3) instructed to depart from the premises, a refusal by the creditor to heed such commands constitutes a breach of the peace.

4. O.R.C. Section 1309.46, U.C.C. 9-503.

5. O.R.C. Section 1317.16.

6. O.R.C. Section 1309.47, U.C.C. 9-504.

7. United States v. Willis, 14 Ohio Op. 3d 443 (6th Cir. 1979).

8. Winters National Bank v. Saker, 66 Ohio App. 2d 31 (Franklin Cty. 1979).

9. O.R.C. Section 1309.48(B), U.C.C. 9-505.

10. O.R.C. Section 1309.47, U.C.C. 9-504.

11. O.R.C. Section 1309.48(A), U.C.C. 9-505.

12. Rules of Civil Procedure 4.1(1)-4.4.

13. O.R.C. Section 2737.

14. Rules of Civil Procedure 5(A).

15. O.R.C. Section 2737.03.

16. O.R.C. Section 2737.08.

17. O.R.C. Section 2737.05.

18. Bash, op. cit., p. 57.

19. O.R.C. Section 2737.01(C).

20. O.R.C. Section 2737.10.

21. O.R.C. Section 2737.19(B).

22. O.R.C. Section 2737.15.

23. O.R.C. Section 2715.01(A).

24. O.R.C. Section 2715.01(A).

25. O.R.C. Section 2715.50.

26. O.R.C. Section 2715.03.

27. O.R.C. Section 2715.03.

28. O.R.C. Section 2715.03.

29. Rules of Civil Procedure 5(B).

30. Rules of Civil Procedure 5(D).

31. O.R.C. Section 2715.041(A) and (C).

32. O.R.C. Section 2715.041(A).

33. O.R.C. Section 2715.041(C).

34. O.R.C. Sections 2715.042 and 2715.043.

35. O.R.C. Sections 2715.10 and 2715.26.

36. O.R.C. Section 2715.43(A).

37. O.R.C. Section 2715.042(A).

38. O.R.C. Section 2715.043(B).

39. O.R.C. Section 2715.044.

40. O.R.C. Section 2715.091 and related sections of Section 2515.

41. O.R.C. Sections 2715.091 and 2715.29; Rules of Civil Procedure 4.2.

42. O.R.C. Section 2737.20.

43. Rules of Civil Procedure 65(D).

44. O.R.C. Sections 2735.01 and 2715.20-25.

45. Epstein, David G, Debtor-Creditor Law in a Nutshell, West Publishing Co., 1980. p. 40.

46. Rules of Civil Procedure 12(A).

47. Bash, op. cit., p. 96.

48. Epstein, op. cit., p. 41.

49. O.R.C. Section 2323.13.

50. O.R.C. Section 2323.13(D).

51. Bash, op. cit., p. 100.

52. State ex rel. Michaels v. Morse, 165 Ohio St. 599 (1956).

53. Miller v. Kyle, 85 Ohio St. 186 (1911).

54. Bash, op. cit., p. 102.

55. O.R.C. Sections 1317.06, 1317.11, 1321.13, and 1343.01-03.

56. Rules of Civil Procedure 69.

57. O.R.C. Section 2333.09-27 and Rules of Civil Procedure 69-71.

58. Rules of Civil Procedure 30(B) and 45.

59. Rules of Civil Procedure 26(B)(3).

60. Rules of Civil Procedure 28.

61. Bash, op. cit., p. 117-118.

62. O.R.C. Section 2333.14.

63. O.R.C. Section 2333.21.

64. O.R.C. Section 2333.22.

65. O.R.C. Sections 2715.01(E) and 2716.01(B).

66. O.R.C. Section 2716.13.

67. O.R.C. Section 2716.13(C)(2).

68. O.R.C. Section 2716.13(C)(2).

69. O.R.C. Section 2716.21(C).

70. O.R.C. Section 2716.21(E) and (F).

71. O.R.C. Section 2329.66(A)(13).

72. O.R.C. Section 3113.21(C).

73. Ohio Rules of Civil Procedure 69.

74. Bash, op.cit., p. 134.

75. O.R.C. Section 2329.13-16.

76. O.R.C. Section 2329.17.

77. O.R.C. Section 2329.20.

78. O.R.C. Section 2329.51.

79. O.R.C. Section 2329.33.

80. Bash, op. cit., p. 142.

BANKRUPTCY

OVERVIEW

Declaration of bankruptcy or being subject to a bankruptcy action of one of the options for dealing with financial stress. There has been a great increase in the number of bankruptcy cases in recent years. The year before the Bankruptcy Code of 1978 there were approximately 240,000 filings in the United States, and for the twelve month period after the new law was implemented there were approximately 500,000 filings. The actual number of individuals involved in bankruptcy filings may be greater than the above statistics indicate. Prior to the 1978 Bankruptcy Code, each individual had to file separately; today a married couple may be involved in one proceeding.1

Bankruptcy is governed by federal law except in the area of property exempted from bankruptcy.2 (Many states have statutes that are either mandatory or elective for exempt property as an alternative to the federal law). A bankruptcy case is a court proceeding under the jurisdiction of the federal bankruptcy courts.

Types of Bankruptcy

There are presently four types of bankruptcy available for farmers: Chapter 7, Chapter 11, Chapter 12, and Chapter 13. Chapter 12 became effective on November 26, 1986 and was written for the family farmer. The chapter numbers correspond to the respective chapter headings within the U.S. Bankruptcy Code.

Chapter 7 deals with the provisions for a complete liquidation. Chapter 11 provides for a reorganization of debt. Chapter 11 is most frequently used by businesses but may also be used by individuals. Chapter 12 provides an alternative for family farms to reorganize debt and continue in the farming business. Chapter 13 provides for a reorganization of debt and is available to individuals, husband and wife jointly, and sole proprietorships with regular income.

Chapters 11, 12, and 13 provide an alternative method to complete liquidation. Within each of these plans the debtor must be able to cash flow the restructured debt repayment plans. A debtor usually can convert from one chapter to another chapter.3 There have been some limitations placed on farmers' ability to convert from a Chapter 11 to a Chapter 12, especially a Chapter 11 filed before the effective date of the Chapter 12 law.

With minor exceptions, the general provisions discussed below apply to all four types of bankruptcy. Specific provisions and any differences in the following general provisions will be discussed for each chapter later in this section.

Filing

A debtor may file a

bankruptcy petition if the debtor is a person who resides or has a domicile, a place of business, or property in the United States or if the debtor is a municipality.4 The debtor does not need to prove solvency or insolvency in order to file a petition.

The initiation of a bankruptcy case may be voluntary or involuntary. If voluntary, the debtor files the petition with the bankruptcy court and recieves relief from creditors as of the time of filing.5 If involuntary, the creditors file the petition.6

Three creditors are required to file an involuntary petition against a debtor; but if a debtor has less than twelve creditors, one creditor may file the involuntary petition.7 In order for creditors to file an involuntary bankruptcy petition against a debtor, the petitioning creditors must have combined claims of not less than $5,000 and must be able to show the debtor's general failure to pay debts as they become due or that a custodian has been appointed within the preceding 120 days.8 Relief for a debtor is not immediate when a plan is filed by creditors but requires a trial upon the allegations and an entry of an order of relief.

Farmers may not be involuntarily placed in bankruptcy.9 To qualify as a farmer a person must have received more than eighty percent of their gross income from a farming operation during the taxable year immediately preceding the petition filing.10 The Bankruptcy Code defines person (including farmers) broadly to include individuals, partnerships, and corporations.11

Protection from an involuntary bankruptcy proceeding does not extend to agribusiness firms. The agribusiness firm does not fit within the specified definition of farming operation.12

Duties of the Debtor

A debtor in a bankruptcy case has several duties. These duties include but are not limited to the list that follows. The debtor must file with the court: a statement of the condition of the business, a list of assets (real and personal property), a list of creditors with addresses, and a list of property requested as exempt from bankruptcy.13 The debtor must cooperate with the trustee (if there is one) in order to enable the trustee to perform the trustee's duties.14 If the debtor is an individual, the debtor must appear at the hearing on discharge.15

Automatic Stay

The automatic stay is one the major debtor protections provided by the bankruptcy laws. It stops all collection efforts, all harassment, and all foreclosure actions. It gives the debtor time to attempt a repayment or reorganization plan.

The automatic stay begins at the time a petition in bankruptcy is filed. The following actions are prohibited during the automatic stay:16
(1) commencement or continuation of proceedings to recover money;
(2) enforcement of judgments;
(3) acts to obtain possession of property;
(4) lien actions;
(5) setoffs;
(6) commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

There are eleven specific categories excepted from the automatic stay.17 They are:
(1) criminal actions;
(2) collection of family support obligations but only from property that is not estate property;
(3) establishment of liens such as mechanics' lien in which value has been given by the creditor and a limited time period is provided to establish the lien;
(4) governmental actions to enforce police or regulatory power;
(5) enforcement of non-money judgments obtained in connection with governmental actions to enforce police or regulatory power;
(6) certain setoff transactions involving commodity contracts;
(7) setoffs in qualified repurchase agreement transactions;
(8) foreclosure actions involving HUD insured mortgages;
(9) tax deficiency notices;
(10) landlord's efforts to recover residential property when the lease has expired;
(11) presentment or notice of dishonor of a negotiable instrument (bank draft, etc.).

The automatic stay is not permanent. The stay is in effect while the property is part of the bankrupt estate unless the automatic stay is lifted, until the case is dismissed, or until the debtor receives or is denied discharge.18 The automatic stay does not relieve the debtor from any obilgations to pay alimony or child support. The stay may be lifted on all property or only specific property of the estate by motion of a creditor to the court and the court sustaining the motion.

Creditor Claims

A creditor is not required to file a proof of claim. A secured creditor who holds a properly perfected lien and value of collateral exceeds the claim has first piority to the secured property. However, the secured creditor must wait to exercise the claim in secured property until the automatic stay is lifted or terminated through a procedure of abandonment of property from the estate, the closing of the estate, or discharge of the debtor.

In general, however, unless a claim is on the list of creditors which the debtor must supply as part of the petition and allowed as a result of the list, a proof of claim will be a prerequisite to allowance for

unsecured claims. This necessity of proof of claim would include priority claims and the unsecured portion of a claim asserted by secured creditors. Debtors may file a proof of claim on behalf of a creditor who fails to make a timely filing.19 A creditor should file a proof of claim when the claim on the debtor's list is incorrectly stated or listed as disputed, contingent, or unliquidated (amount is yet to be determined). A codebtor, surety, or guarantor may file a proof of claim on behalf of the creditor to which the debtor is liable if the creditor does not timely file a proof of claim.20

Priority of Claims

Secured creditors who have possession or who have filed to perfect their security interest have priority over unsecured creditors. The order of priority for unsecured creditors is listed below in order as established by the Bankruptcy Code:21

(1) administrative expenses;
(2) proof of claims in an involuntary case filed by unsecured creditors for claims arising in the ordinary course of business after commencement of the case;
(3) allowed unsecured claims for wages, salaries, or commissions, including vacation, severance, and sick pay leave earned by an individual within 90 days before the petition was filed up to $2,000 for each individual;
(4) all unsecured claims for contributions to an employee benefit plan arising from services rendered within 180 days before the date the petition was filed for each plan, up to $2,000 for each employee, less the amount paid for salaries, etc. in 3 above;
(5) unsecured claims of persons engaged in the production or raising of grain against a debtor who owns or operates a grain storage facility for grain or the proceeds of grain to the extent of $2,000 for each such individual;
(6) allowed unsecured claims of individuals, to the extent of $900 each, arising from the deposit (before the petition) of money in connection with the purchase, lease, or rental or property or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided; and
(7) allowed unsecured specific claims of governmental units.

The bankruptcy code strives to give fair treatment to all creditors. Transfers of property of the debtor made prior to the filing of the petition are scrutinized to make sure specific creditors do not gain preferential treatment over other creditors. The bankruptcy code provides a trustee with the status of a lien creditor which enables the trustee to avoid transfers of property obligations made by the debtor that are voidable by law.22 The trustee may also avoid certain statutory liens.23 The trustee may avoid certain

transfers of interest of the debtor in property, including transfers made while the debtor was insolvent, transfers made within 90 days of the filing of the petition, or transfers made between 90 days and one year before the filing of the petition if the creditor benefited by the transfer was an insider.24

As noted above, the debtor must be insolvent as of the time of the filing of the petition in order for the trustee to avoid certain transfers of interest in property. Insolvent is defined in the code to be such that the sum of the debtor's debts exceeds the fair market value of all of the debtor's property.25

The trustee's avoiding powers are limited to two years after appointment or when the case is closed or dismissed, whichever is later.26 The trustee does not have unlimited avoiding powers under the code. A creditor, whose security interest is perfected, has priority over the trustee. A creditor whose security interest is not perfected at the time of the petition in bankruptcy is filed may become perfected against the trustee where the law allows a temporary perfection prior to actual perfection.27 Under statutory or common law rights accorded a seller, goods received on credit by the debtor while insolvent may be reclaimed by the seller.28 A producer of grain who sells to a grain storage facility, owned or operated by the debtor may reclaim grain under any statutory or common law right for producers of grain if ten days written notice is given to the debtor. However, the court may deny reclamation of the grain and secure the claim by a lien instead.29

Property in the Bankrupt Estate

The filing of a voluntary or involuntary petition creates an estate in bankruptcy.30 Generally, all property in which the debtor has a legal or equitable interest at the time of the filing of a bankruptcy is part of the bankrupt estate and subject to the proceedings. The bankrupt estate also includes property acquired within 180 days of the filing by inheritance, property settlement of a divorce decree, and proceeds of life insurance policies.31 In addition proceeds from offspring, rents, or profits from the property of the estate are included in the estate.32

The estate in bankruptcy may use property of the estate, sell it or lease it in the ordinary course of business without prior approval.33 If a sale or use is not within the ordinary course of business, authority from the court is required after notice and a hearing.34 The debtor may not use cash collateral without the consent of the secured party or a court hearing which determines whether the interest of the secured party is adequately protected.35 (The sale of pledged

inventory or equipment or collection of accounts results in cash collateral.)

Timing of the filing of bankruptcy can determine what property is included in the estate. For farmers this may be an important concept. The bankruptcy statute states that the bankruptcy estate is comprised of property the debtor had legal and equitable interest in at the time of filing.36 Some courts have held that crops yet to be planted are not property of the estate. As a result creditors who have continuing crop liens may not be able to have those liens continue in the crops yet to be planted. This can free up some prceeds and make cash flow planning easier. Also, cutting off the continuing liens may enable financing of the current year's crops by allowing a super priority lien to those creditors who help the debtor continue in business.37

Exempt Property

A limited amount of property may be exempted from the bankrupt estate. In Ohio, exempt property is defined by state statute rather than by federal statute.38 The following represents selected items which are exempt from the bankrupt estate in Ohio:
(1) $5,000 of real or personal property used as a residence39;
(2) $1,000 in a motor vehicle;
(3) wearing apparel, beds, and bedding (except where any one item has a value greater than $200), $300 in a stove, and $300 in a refrigerator;
(4) $400 in cash on hand or cash receivables;
(5) household or personal items that do not have a value greater than $200 each, one item of jewelry with a value of $400 and any other items of jewelry that do not exceed a total of $200 (exempt household or personal items and jewelry cannot exceed $1,500 but where no exemption was taken for property used as a residence the exemption limit in this category becomes $2,000);
(6) $750 for tools of trade;
(7) life insurance, endowments, and annuities;
(8) sickness and health insurance;
(9) health aids;
(10) burial lot; and
(11) workmens' compensation, unemployment compensation, and social security benefits.

If the debtor fails to file a list of property to be exempt from bankruptcy, a dependent of the debtor may file such a list, or may claim property as exempt from property of the estate on behalf of the debtor.40 The permitted exemptions apply to each debtor separately in a joint case.41 Joint cases usually are husbands and wives.

Discharge in Bankruptcy

Discharge in bankruptcy excuses the debtor from paying particular debts. This provision enables the debtor to obtain a fresh start relatively free from debt. The debtor still owes the debts and may choose to repay but no creditor on a discharged debt can legally enforce payment.42 Certain

debts may not be discharged, including taxes for a tax year ending before the date of filing bankruptcy and within the statute of limitations for collection (usually 3 years after a return is filed); alimony; maintenance and support; payments due after completion of the plan; debts not provided for in the plan; debts incurred due to intentional tort by the debtor; fines owed to governmental units; and reaffirmed debts.43

CHAPTER 7

The purpose of Chapter 7 is to liquidate assets for the payment of creditors and to provide a fresh start for the individual debtor through discharge. Most Chapter 7 cases are filed voluntarily by the debtor.44 A Chapter 7 filing may be the only option if the secured debt cannot be cash flowed in a Chapter 11, 12, or 13.

Who May File a Petition

Any person that is not a railroad, a domestic or foreign insurance company, bank, savings bank, cooperative bank, savings and loan, etc. may be a debtor under Chapter 7.

Election of a Trustee

An interim trustee is appointed by the court promptly after the filing of the petition.45 The interim trustee serves until a permanent trustee is elected by the creditors.46 The trustee has several duties which include collecting all property of the estate and reducing the property to money, ensuring that the debtor performs necessary duties, investigating the debtor's financial affairs, examining the proofs of claims made against the estate, opposing the discharge of the debtor if necessary, furnishing information concerning the estate and administration of the estate to a party in interest, preparing and filing with the court a final report and accounting of the administration of the estate.47

Creditor Committee

A meeting of creditors should take place soon after the granting of relief by petition. At this meeting creditors may elect a permanent trustee to serve in the case. A creditor that holds an allowable, undisputed, fixed, liquidated, unsecured claim and does not have an interest materially adverse to other creditors may vote for such trustee. If a trustee is not elected, the interim trustee appointed by the court becomes the permanent trustee.48

At this same meeting, the creditors that may vote for a trustee may elect a committee of three to eleven creditors that will consult with the trustee in connection with the administration of the estate. This committee may make recommendations to the trustee regarding the performance of the trustee's duties and submit to the court any questions affecting the administration of the estate.49

Conversion

A Chapter 7 case may be converted by the debtor to either a Chapter 11, 12, or 13 at any time unless the case has already been converted from such a chapter. Any waiver of the right to convert by the debtor is not enforceable.50 The court may at any time convert a case under Chapter 7 to Chapter 11 on the request of a party in interest after notice and a hearing. The court may not convert a case under Chapter 7 to a case under Chapter 12 or Chapter 13 unless the debtor requests the conversion.51

Chapter 11, 12, and 13 cases may be converted to a Chapter 7. Except that farmers cannot be involuntarily converted to a Chapter 7 liquidation. The Chapter 12 law does allow a farmer to be involuntarily converted if fraud if proven.

Authorization to Operate Business

The court may authorize the trustee to operate the business of the debtor for a limited time, if the operation is in the best interest of the estate and consistent with orderly liquidation of the estate.52

Redemption by Debtor

An individual debtor under Chapter 7 may redeem tangible personal property intended for personal, family, or household use from a lien securing dischargeable consumer debt if such property is exempted or has been abandoned by the creditor.53 The redemption may be accomplished by paying the holder of the lien the amount of the allowed secured claim of the lien. This gives the debtor a right to redeem consumer goods that might be repossessed.

CHAPTER 11

A petition in Chapter 11 allows the farmer or other business owner to continue managing the business under the supervision of a committee of creditors. Chapter 11 gives the debtor and the creditor a chance to negotiate and compromise. If the business can be held together, the business may be more valuable as a unit than when separate portions are liquidated. Therefore, a creditor may receive more benefit under a successful Chapter 11 reorganization than gained under a plan of liquidation.

Who May File a Petition

Any farmer (individual, partnership or corporation) qualifies as a debtor under Chapter 11. Any person or business can file under a Chapter 11 except a railroad, insurance company, stock broker or commodity broker.

The Business

The business continues to be managed by the operator (farmer) as debtor in possession. The operator's management is supervised by a committee of creditors. 54 The committee is composed of the unsecured creditors who have the highest claims and are willing to serve.55

A trustee may be appointed in place of a debtor if fraud, incompetence or gross mismangement can be shown.56 The court may appoint an examiner instead of a trustee.

Reorganization Plan

The debtor must submit a plan for reorganization to the court which must be confirmed by creditors. This confirmation process has been an obstacle in many farm Chapter 11 bankruptcies. During the first 120 days after the petition is filed, the debtor has the exclusive right to submit a plan for reorganization.

A farmer cannot be converted involuntarily from a Chapter 11 reorganization to a Chapter 7 liquidation.57

A farmer who voluntarily files a petition in Chapter 11 should make every effort to get a plan of reorganization confirmed during the exclusive period for the debtor. Where a farmer has voluntarily petitioned to be in Chapter 11 and then fails to have a plan for reorganization confirmed during the 120 day exclusive period, the debtor's creditors can propose a plan of their own. The farmer's creditors can propose a plan of liquidation through Chapter 11.

The plan may take many forms, including a simple composition of the debts, sale of the some of the assets, or sale of the business to another party The plan must group the claims or interests by classes.58

It is this provision which causes secured creditors to receive a plan for payment and for unsecured creditors to be greatly impaired.

Impaired means the creditor will receive less than the full amount of the claim. Unsecured creditors could receive as little as zero. Secured creditors must receive the amount equal to the fair market value of the collateral at the date of filing. These payments may be ammortized.

The plan must set out the treatment which each class is to receive under the plan.59 Classes which hold priority claims must be specially organized and full payment to the extent of the value of the claim is mandatory unless the parties agree otherwise although the payment may be deferred.60 Proper grouping is critical relative to the confirmation of the reorganization plan since classes vote according to a weighted majority.

Plan Modification

A proposed plan for Chapter 11 reorganization may be modified. The proponent of a plan may modify the proposal at any time before confirmation.61 The proponent of a plan or the reorganized debtor may modify the plan at any time after confirmation of the plan and before substantial performance of the plan.62

Disclosure Statement

When a debtor proposes a

plan, the court must approve a disclosure statement prepared by the debtor to inform the voting creditors before a vote is taken. The statement must indicate the treatment each impaired class will receive or the fact that a class is not impaired. The statement must indicate what the liquidation returns would be for each class if the debtor were to be liquidated under Chapter 7.

The disclosure statement hearing is mandatory. After approval of the disclosure statement, ballots to the various classes are distributed along with a copy of the disclosure statement.

Creditors

Creditors need to file a proof of claim under Chapter 11 the same as described in the overview with the following exception. Because of the importance of the debtor obtaining new and additional credit in order to make the Chapter 11 reorganizaton successful, creditors who do business with the estate debtor after the case is commenced may be paid immediately. If such creditors are not paid immediately, they are creditors with a first priority claim as an administrative expense.63

For farmers this priority which can be given to suppliers may make it feasible to obtain production imputs for the next operating season. This provision makes timing of electing farm bankruptcies important. If the election is made after the suppliers have extended credit for production they can not receive a priority.

Unsecured creditors often view post-petition borrowing by the debtor as a threat to their distribution in the reorganization.64 Actually post-petition creditors are placed in a favored position to the extent of the credit given after filing.

The law sets forth a procedure for those who have claims against the estate to accept or reject the proposed plan. The plan can be accepted by a vote of the creditors even if certain creditors object.65

Effect of Confirmation

Confirmation is an all important event for the debtor. Confirmation binds the debtor, creditors and other parties with an interest (partners, shareholders, etc.) in the estate. Creditors and other parties with an interest are bound whether or not they voted for the plan. 66 Once the plan is confirmed the debtor is charged with the responsibility of carrying it out.67 Confirmation has the effect of discharging the debtor of all debts which were listed but not provided for in the plan.68 Except non-dischargable debts, as indicated in the discharge from bankruptcy section of the overview, will remain as obligations of the debtor.69

CHAPTER 12

The Family Farm Bankruptcy Act of 1986 was signed

by the President on October 27, 1986, and became effective on November 26, 1986. The law will terminate on October 1, 1993 unless the legislature extends it.

Although the new law has received positive review, its use by any farm family should be carefully evaluated by both the the family and their counselors. There are advantages and disadvantages to the law.

There are now four different bankruptcy provisions which farmers can use. These are: Chapters 7, 11, 12 and 13. For most farmers the choice will be either Chapter 7 or 12. For tax reasons there are a few situations where a Chapter 11 may be the better choice.

Chapter 12 was written specifically for farm families in light of the current financial dilemma. Courts are expected to make rulings in consideration of this legislative objective that will be of assistance to farmers. This does not mean that all farmers will be able to be successful as they work through a Chapter 12. However, the success rate should be better than has been experienced when using Chapter 11.

The purpose of Chapter 12 is similar to the other provisions of bankruptcy, to provide a fresh start. When more loans are owed then can possibly be paid, debtors are not put in jail but rather the law provides a way of giving them a chance for a new start.

Even if Chapter 12 does appear to be more favorable to farm debtors than the other relief provisions of bankruptcy, one must realize that it is still bankruptcy. Once bankruptcy is filed the debtor is under the jurisdiction of the court. This jurisdiction continues until a discharge has been obtained from the court. Also, there is a stigma which goes with bankruptcy even though it is less than a few years ago.

Chapter 12 relies on many of the concepts of other chapters in the bankruptcy code. Some of these important concepts are automatic stay, adequate protection, priorities of claims, discharge, nondischarable claims, fraudulent transfers, and preferential transfers.

This is a new law and it is expected that several court interpretations will have to be made. This being the case, some court procedures will be slowed and additional costs may be incurred by those helping to determine the parameters of the new law.

There continues to be the question of how long negotiations outside of bankruptcy should first be pursued. Many farmers, creditors and their respective counselors have worked hard at finding solutions outside of bankruptcy. Some counselors feel creditors may be even more willing to negotiate before a bankruptcy is filed with the advent of Chapter 12

and the favoritism it may present to farmers.

Any farmer electing to file a Chapter 12 will want to be ready to aggressively proceed to develop a work out plan. The debtor is responsible for presenting a plan for restructuring the debt within 90 days of filing. With a Chapter 11 the plan must be presented within 120 days and many of those plans have not been timely filed. The Chapter 12 law allows extensions beyond the 90 day period but this is one provision courts are expected to monitor closely and to grant extensions sparingly. Under a Chapter 11 creditors are permitted to file a plan if the debtor does not timely file. Under Chapter 12 the creditors do not have the option of filing a plan, rather they can ask to have the case dismissed. Some attorneys are suggesting the plan should be prepared before filing for bankruptcy under this new law.

The plan presented by the farmer is the proposal for restructuring payments to creditors. Within that plan secured creditors are to receive amortized payments based upon the worth of the assets in which they have security as of the date of filing. Many secured creditors actually have a portion of their debt which is unsecured because the fair market value of the secured assets has dropped below the outstanding loan. The plan must also set forth how unsecured creditors will be paid. Many times unsecured creditors receive little or nothing. The assurance unsecured creditors are to have with a Chapter 12 is that they receive the same amount as they would under a Chapter 7 liquidation. That concept has not changed from that of a Chapter 11 or 13.
Some plans are allowing for a small payment to unsecured creditors because there are personal assets which the debtor retains possession of in the Chapter 12, while in a Chapter 7 liquidation those assets would be liquidated and a small payment made to the unsecured creditors. This is based on the concept that unsecured creditors in a Chapter 12 are to receive as much as they would in a Chapter 7 were filed.

A Chapter 12 plan is to be accomplished within three years but the court can grant an extension up to five years. Secured creditor's loans need to be amortized over some reasonable length of time commensurate with traditional loans for the subject assets. Loans secured by real estate, equipment, and breeding livestock may not be able to be paid off during the three to five year period but may be put on a payment schedule which is feasible and practicable for the type of asset. The unsecured creditor portion of the debt will need to be paid within the three to five year period in an amount at least equal to what they would have received if the assets had been liquidated on the date

of filing.

One of the provisions of Chapter 12 which makes it more favorable for farmers than Chapter 11 is that unsecured creditors cannot vote for or against the acceptance of the plan. Secured creditors do have a right to indicate acceptance or rejection of the plan. Unsecured creditors can file an objection to the plan with the court and if that is done then the court must be sure the plan provides for payment in full of unsecured claims OR that all of the debtors disposable income is used to make payments under the plan. Disposable income means income which is received by the debtor and which is not reasonably necessary to expend for (a) the maintenance or support of the debtor and dependents of the debtor; or (b) the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business. It is this proviso that only the disposable income be used to fund the plan which causes unsecured creditors to be paid less than their claim.

The adequate protection portion of Chapter 12 law has caused concern for secured creditors. The adequate protection provided to secured creditors can be met in one of four ways: requiring payments to secured creditors for any decrease in value of the secured property; allowing an additional lien in property of the estate to offset any decreasing value of secured property; providing reasonable rent payments to the secured party for farmland; or granting other relief which will adequately protect the secured party.

Creditors have been concerned about the possibility of reducing payments made on farmland to the fair rental value. For many farmers the debt payments on farmland are considerably greater than today's rental market. The possiblity of obtaining adequate protection for creditors is granted until a plan gets confirmed. With the shortened time for filing a plan, 90 days from date of filing bankruptcy plus the period of up to 45 days until confirmation of the plan, at most only 135 days should pass until a creditor's payments are provided for under the plan. After this analysis most creditors should not be so concerned about the possibility of reduced adequate protection until the plan is confirmed.

The debtor, the secured creditors and the unsecured creditors are all going to be very interested in the value placed on assets. Each of the parties has a different perspective. The secured creditors want the secured assets to have a high value. This would permit them to receive a greater percentage of the dollars from the estate over time. The unsecured creditors favor a low value on secured assets and a high value on unsecured assets. This should enable a greater payment to them. The

debtor favors a low valuation on all assets which allows more debt to be forgiven.

The feasibility of developing a positive cash flow within a Chapter 12 will be a challenge. In most cases it will be like 100 percent financing. The advantage is that the 100 percent financing will be related to the current value of assets, not the past higher values. For most farming operations 100 percent financing has not been possible.

Some codebtors (persons who have signed as a surety on another's debt) will have protection as a Chapter 12 is filed. The law provides that codebtors on consumer debt will enjoy a stay. Debt related to the business of farming is not consumer debt and therefore most codebtors will not have the advantage of the stay.

A Chapter 12 is like a Chapter 11 in that the farmer continues to operate the farm. The farmer is known as the debtor in possession. There are new accounts created in the farmer's name with a suffix, debtor in possession. At times the farmer may be removed by the court from being the debtor in possession after a motion by a creditor. If a creditor can prove fraud or gross mismanagement, the court will likely be convinced that a removal should be granted.

It is the trustee's responsibility to make the payments to creditors provided under the plan. Such payments are made after the debtor in possession has transferred the funds to the trustee. The trustee can, to some extent, be considered as overseeing the fulfillment of the plan. In a Chapter 11, a trustee is appointed when the debtor is not permitted to be a debtor in possession. In a Chapter 13 the trustee manages the plan.

One concern about the trustee plan is the cost. Trustees get paid a perentage of the payments made under the plan. The law provides for a trustee fee of up to 10 percent of such payments. This may threaten the feasibility of some plans. Courts are monitoring the trustee fees to determine what a fair fee is, this is happening on a case by case basis.

Another concern is that Chapter 12 does not have some of the tax advantages available in a Chapter 7 or 11. Upon the filing of a Chapter 7 or 11 creates a new tax entity is created for individuals for federal tax purposes. This means taxes generated within bankruptcy are the responsibility of the estate not the individual. Chapter 12, under current tax law, never creates a new tax entity for federal taxes and federal taxes of the estate remain the responsibility of the individual after discharge. Chapter 12 does create a new tax entity for state and local taxes.

Chapter 12 is not a revolutionary new idea. It

will not be a panacea for all farmers in financial difficulties. There are some advantages to farmers not presently in other reorganization chapters. The major advantages are: a write down of secured debt to current fair market values, no provision for voting by general creditors on the acceptance or nonacceptance of the plan; the adequate protection available to secured creditors' of farmland is lessened, and the plan is to be fulfilled in the three to five year period, contrasted with no set time for a Chapter 11.

An Explanation of the Code Sections

Following is an explanation of the provisions of the Chapter 12 law. This explanation follows the law as written, section by section. A study of the explanation in comparison with the law should aid in understanding. Section references are to the amended title 11 of the United States Code, which is the Bankruptcy Code.

Definition of Family Farmer[70]

A family farmer is an individual, or an individual and spouse, operating a farm whose total debt does not exceed $1,500,000 of which 80 percent is related to the farming operation. If the debt on the residence is separate from the farm debt that debt is not used as the 80 percent is calculated. These tests do not include undetermined amounts for which a family might become responsible; i.e., a pending law suit for an accident. The farm family must have also received 50 percent or more of their gross income from farming during the tax year preceding the year of filing bankruptcy.

It is also possible for a partnership or a corporation to be considered a family farmer and to file under Chapter 12. The partnership or corporation must meet the $1,500,000 and 80 percent tests of the above paragraph the same as an individual. In addition, 50 percent or more of the stock or equity must be held by one family and relatives of the family. The same family or relatives must be operating the farm. Also, 80 percent of more of the value of the assets in the partnership or corporation must be related to the farming operation. The stock of a corporation cannot be publicly traded.

In addition to the above tests the family farmer must have an annual income which is sufficiently stable and regular to enable payments under the plan which is filed with the court. This is a subjective test which may be contested in court. It would seem the best time to meet this test would be in the preparation of a defendable plan.

A farming operation which cannot meet these definitions still has the other chapters of bankruptcy available. Those are chapters 7, 11, or 13.

Stay Against Codebtors[71]

Stay is a common concept in bankruptcy. In the broadest of terms stay means collection efforts of the creditor are put on hold. Under other chapters of the bankruptcy code as well as in Chapter 12 stay is granted to the person or persons filing bankruptcy. Within Chapter 12 stay is also granted to a codebtor on a consumer debt. Note this stay is granted to codebtors for consumer type debt only, not business debt.

The creditor has the right to ask the court for relief from this stay. If the court grants the relief the codebtor again becomes liable. If a creditor files a motion for relief from stay, the debtor or codebtor must file an objection within 20 days or the stay will be lifted without an opportunity to object.

Trustee[72]

Chapter 12 bankruptcy cases will have a trustee appointed. The trustee is basically responsible for monitoring the plan of payments to creditors. The trustee has the ability to question the valuation of property brought into the bankruptcy, the confirmation of the plan, any modification to plan and the sale of any of the property in the bankruptcy, Also, if the farmer ceases to be the debtor in possession the trustee shall perform the duties of the debtor in possession.

The statute states that the trustee is paid a percentage of the payments made under the plan. The percentage shall be 10 percent of the first 450,000 and 3 percent on amounts over $450,000. It may be possible to negotiate lower payments.

The trustee within a Chapter 12 has similar duties to the trustee within a Chapter 13. Under a Chapter 11 usually no trustee is appointed.

Rights and Powers of Debtor[73]

The debtor, farmer, shall be responsible for continuing to operate the business. The debtor is responsible for filing: a list of creditors, a schedule of assets and liabilities, a schedule of current income and expenditures, a statement of the debtor's financial affairs, and a plan. The plan is discussed at section 1221 and 1222.

Removal of Debtor as Debtor in Possession[74]

The farmer may be removed from being the debtor in possession upon court order. The court order may be given upon a party in interest, likely a creditor or the trustee, making such a request. Reasons for such a request would include fraud, dishonesty, incompetence, or gross mismanagement. The removal of the debtor in possession by the court can only happen after notice to the debtor and a hearing. The debtor can be removed at any time throughout the bankruptcy proceeding. It is also possible for the debtor to be reinstated as debtor in

possession.

Adequate Protection[75]

A secured creditor is entitled to adequate protection after bankruptcy has been filed. This means the creditor's position should be able to be protected from further deterioration. A creditor is entitled to adequate protection because of concepts like stay; use, sale or lease of property in the bankruptcy; and the debtor being able to grant a priority to creditors who enable the operation of the business after the filing of bankruptcy.

Adequate protection may be provided by: 1) requiring cash payments to a creditor; 2) providing an additional or replacement lien; 3) paying the farmland creditor a reasonable rent based upon rental value, net income and earning capacity of the property; or 4) the granting of such other relief as will adequately protect the value of property securing a claim or of ownership interests in leased property.

The Chapter 12 law introduces one new concept into adequate protection which has troubled real estate creditors. That is the concept of a fair rental payment in lieu of the regular amortized payments. This can be a drastic reduction in the payments. Creditors are responding by indicating they will not be focusing as much on adequate protection until after the confirmation of plans is achieved. After a plan is confirmed payments are made according to that plan and adequate protection is not a key issue.

Sales Free of Interests[76]

This provision mainly stops blockage of a sale of farmland or equipment by a creditor. The creditor is protected by having their interest attach to the proceeds from the sale. Any sales under this provision are by the trustee and only after notice and a hearing.

Property of the Estate[77]

The bankruptcy estate includes, basically, all the property of the farmer brought into bankruptcy, plus property acquired by the farmer after date of filing plus earnings from services performed by the farmer and spouse, if spouse also filed, after the date of filing.

Conversion or Dismissal[78]

A Chapter 12 case can be converted to a Chapter 7 upon request of the debtor. This request will not be granted if the case has previously been converted from Chapter 7 or 11 to Chapter 12. Also, on request of the debtor the court shall dismiss a case under this chapter.

It is also possible for a creditor, trustee or other party in interest to request a dismissal from a Chapter 12. Such a dismissal can only be granted after notice and a hearing.

Reasons a party in interest might request a dismissal include: unreason-

able delay or gross mismanagement by the debtor to the detriment of creditors; nonpayment of fees and charges; failure to timely file a plan; failure to commence making timely payments set forth by a confirmed plan; denial of confirmation of a plan and denial of a request for additional time to modify the plan or file another; material default by the debtor in meeting terms of a confirmed plan; revocation of a confirmed plan and denial of acceptance of a modified plan; meeting of the conditions set forth in a confirmed plan; or continuing diminution of the estate with little chance to change the situation.

A Chapter 12 case can be converted to a Chapter 7 or dismissed upon a showing that the debtor has committed fraud. This is the only provision of the bankruptcy code which allows involuntary liquidation of a farmer.

The creditor's ability to request a conversion or dismissal for one of many reasons should cause debtors to comply with deadlines and attempt to manage the business according to the plan. If a dismissal occurs the protection of bankruptcy is lost.

Filing the Plan[79]

The plan for making payments to creditors must be filed within 90 days of the date of the order for relief. The order for relief is considered to granted on the same day the bankruptcy is filed. The court may grant an extension of this 90 day deadline but only if facts show the reasons are substantially justified. It is anticipated extensions will only be granted for unusual circumstances.

Contents of the Plan[80]

The plan sets forth how creditors of the bankruptcy estate are to be compensated. The funds which are to be dispersed to creditors are submitted to the trustee for supervision and control.

The plan is to provide for full payment of claims entitled to priority. Those claims include: administration expenses; up to $2,000 of wages earned by each employee within 90 days before filing the bankruptcy; claims of up to $2,000 for contributions to employee benefit plans per employee; deposits of up to $900 per individual for the purchase, lease, or rental of personal, family or household goods or services; and unsecured claims of governmental units.

The plan is to provide equal treatment for each claim within a particular class of claims. The plan may provide the following: a class or classes of unsecured creditors; modify the rights of holders of secured or unsecured claims; for the curing or waiving of default; for the payment of unsecured claims concurrently with the payment of secured claims; curing of default and the maintenance of payments while the case is pending on claims

which will not be paid entirely until after the case is dismissed; for the assumption, rejection, or assignment of any executory contract (contracts to be completed in the future); for payment of a claim from property of the estate; for the sale or distribution of all the property of the estate; for payment of secured claims for a period which exceeds the bankruptcy; for vesting of the property in the debtor on confirmation of the plan; and include other appropriate provisions.

The plan is to provide for completion within three years. However, payments for secured claims may extend beyond the period of bankruptcy. The court may, for cause, extend a Chapter 12 up to no longer than a total of 5 years.

Modification of the Plan Before Confirmation[81]

A debtor may modify the submitted plan any time before confirmation so long as the modification meets the criteria for plans set forth under contents of the plan.

Confirmation Hearing[82]

The court shall hold a hearing on the plan to achieve confirmation. Creditors (secured and unsecured), trustees and other parties of interest may object to the confirmation. The hearing and confirmation are to be concluded within 45 days after the filing of the plan. For cause the court may grant an extension of this 45 day period. Confirmation hearings may be very involved. Appraisal values and feasibility of the plans are often the focus of the hearing.

The law attempts to have plans submitted and confirmed within 135 days of the filing date. This is a short time period purposely set to expedite Chapter 12 proceedings.

Confirmation of the Plan[83]

This section identifies the standards for court acceptance of the plan submitted by the debtor. Those tests are: 1) the plan must comply with the provisions of Chapter 12 law; 2) amounts to be paid before confirmation have been paid; 3) the plan is proposed in good faith; 4) each unsecured claim must receive an amount equal to or exceeding what would have been received if the debtor would have liquidated on date of filing; 5) each holder of a secured claim has accepted the plan, retains a lien on the secured property, receives a value for the claim not less than the value on the effective date of the plan, or that the property is turned over to the creditor; and 6) the debtor will be able to make payments under the plan.

Holders of unsecured claims do not have the ability to accept or reject the plan. Unsecured creditors may file an objection to the plan. If such an objection is filed the court may not approve the plan unless, either such claim or claims are paid in full or all

disposable income in the 3 to 5 year period is applied to make payments under the plan. Disposable income means income which is received by the debtor and which is not reasonably needed for support of the debtor and his dependents or for expenditures necessary for continuation, preservation, and operation of the business. Often the amount of disposable income is very limited and the unsecured creditor receives little or even zero.

Payments[84]

All payments made to creditors under the plan are to be made by the trustee. Funds received prior to confirmation of the plan are to be held by the trustee. If the plan is not confirmed the funds held by the trustee shall be returned to the debtor after expenses incurred in filing and management of the bankruptcy to the date of dismissal are paid. If the plan is confirmed the trustee shall make all payments to creditors under the plan. Before such payments are made to creditors, the trustee shall be sure the priority expenses identified in the section on contents of the plan and trustee fees are paid.

Effect of Confirmation[85]

Confirmation of a plan is an important event. Confirmation has the effect of binding the debtor, creditors, partners in the case of a partnership and equity holders in the case of a corporation. This effect of binding is true whether or not a creditor accepted the plan and whether or not a creditor receives payments under the plan.

Discharge[86]

Discharge is to occur as soon as possible after the debtor has completed payments under the plan. Discharge releases the debtor from all debts provided for under the plan with some exceptions. If the plan provided for continued payments to secured creditors over a time longer than the bankruptcy period those future payments are not discharged. If the debtor elected by filing a waiver with the court prior to obtaining a discharge to have certain dischargeable debts continue those debts would not be discharged. Creditor claims which were not listed when the bankruptcy was filed are not discharged. Certain claims are not dischargeable in bankruptcy; i.e., certain taxes; credit obtained under false pretenses; alimony, maintenance or support payments owed a former spouse or a child under court order; and certain student loans.

Modification of the Plan After Confirmation[87]

A plan may be modified during the bankruptcy period on request of the debtor, the trustee, or the holder of an allowed unsecured claim. Reasons for modifying a plan are: 1) to increase or reduce the amount of payments on claims of a particular class, 2) to extend or reduce the time for payments, or 3) to alter the payment to a particular creditor if payments have been made to

that creditor other than under the plan. Extensions cannot cause the bankruptcy to continue beyond 3 years unless the court approves an extension, which may extend the period up to a total of 5 years.

Revocation of an Order of Confirmation[88]

A party in interest, usually a creditor or the trustee, can request a revocation of a confirmed plan. The reason for such a request would be if a confirmation was obtained by fraud. A request for revocation must be made within 180 days after confirmation.

Special Tax Provisions[89]

This section of Chapter 12 law relates only to state and local taxes, not to Federal taxes. Any state or local income taxes resulting within the bankruptcy estate will be the obligations of the estate, not in any way the independent responsibility of the debtor. Also any state or local taxed imposed because of property transfers to or from the bankruptcy estate are to be waived. For example, the transfer tax in Ohio is the tax imposed when real estate ownership is changed.

It is important to note that this section does not relate to Federal taxes. With Chapters 7 and 11 any federal income taxes incurred within the estate are not the responsibility of an individual debtor. This federal tax shelter within Chapters 7 and 11 is not extended to partnerships or corporations, just to individuals. The possibility of taxes remaining the responsibility of Chapter 12 debtors should cause some individual debtors to file a Chapter 7 or 11 if major federal taxes liabilities are projected.

Conversion from Chapter 11 to Chapter 12[90]

This section of the law makes it possible for a debtor to request the court to convert a Chapter 11 case to Chapter 12. Other sections of the code make it possible for a Chapter 11 bankruptcy to be converted to a Chapter 13 if the debtor qualifies. The code in other sections also makes it possible to convert from a Chapter 11, 12, or 13 to a Chapter 7. Several courts, not all, have denied conversion from Chapter 11 to Chapter 12 if the Chapter 11 was filed prior to the new law becoming effective.

Farmers cannot be forced to convert to a Chapter 7 liquidation plan from a Chapter 11, 12, or 13 with one exception. The Chapter 12 law permits an involuntary conversion from a Chapter 12 to a Chapter 7 by the court upon a showing that the debtor has committed fraud.

CHAPTER 13

Chapter 13 differs substantially from Chapters 7 and 11.[91] In Chapter 13 the creditors have no vote. The secured creditors have only an opportunity to rejector accept the proffered treatment under the Chapter

13 plan. Cram down of secured creditors in Chapter 13 is a likely result. The Chapter 13 plan must be filed with the Chapter 13 petition or shortly thereafter. The thrust of Chapter 13 is toward confirmation of the plan and not negotiation as in Chapter 11.

Chapter 13 is voluntary only; an involuntary Chapter 13 is not possible. Chapter 13 is available to individual debtors only; a partnership or corporation petition in Chapter 13 is not possible. Although Chapter 13 is dominantly used by wage earning consumer, it is not limited to that group. A small sole proprietorship may be eligible.92 Some farmers have filed Chapter 13 plans.

Only an individual with regular income and such individual's spouse, except a stockbroker or a commodity broker, that owe, on the date of filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than $100,000 and noncontingent, liquidated, secured debts of less than $350,000 may be a debtor under Chapter 13.93

The basic concept of Chapter 13 is an installment repayment by composition or extension using income received after the commencement of the case.94 In Chapter 13 the debtor retains possession of all estate property.95 The appointment of a trustee is automatic and in most large districts, the trustee will be a standing trustee for all Chapter 13 estates.96 The Chapter 13 trustee is to collect income on behalf of the debtor pursuant to Bankruptcy Code Section 1325(b) and to dispurse payment to the creditors as called for by the confirmed plan under Bankruptcy Code Section 1326(b). The Chapter 13 trustee is to make a general examination of the debtor's affairs97 and, where there is a business Chapter 13 debtor, the trustee is to make an investigation and report.98

For a consumer debtor, the trustee must approve post-petition incurrence of credit obligations or the creditor may not participate in the plan payments.99 The Chapter 13 trustee may be an adversary of the debtor who must be heard upon the issues of valuation of the encumbered property, feasibility and confirmation of the debtor's proposed plan and objections to the debtor's discharge.100

Prior to filing the Chapter 13 petition, the debtor must determine the budget needs for the family in order to determine the excess available for payment to creditors. Since Chapter 13 is available to an individual only and the exemptions apply. The debtor may use property which would otherwise be set aside as exempt to pay creditors. There is no obligation for the debtor to use exempt assets in payment of creditors. How- ever, the debtor's plan may be rejected

if only nominal payments are offered to creditors.

The automatic stay provided by Section 362 of the Bankruptcy Code applies in Chapter 13 cases. In addition, the Chapter 13 automatic stay may protect co-debtors, along with the Chapter 13 debtor, against collection of debts.101 The co-debtor stay relates to consumer debts only. Business debts, even with a co-debtor, are not protected.

Proper classification of creditors in Chapter 13 is a point of conflict only partially resolved by 1984 amendments. Some Chapter 13 plans seek to provide full payment to those creditors holding claims protected by a co-debtor and smaller payment to other creditors. Claims classification serves a different purpose in Chapter 13 than in Chapter 11. Unsecured creditors do not have a vote in Chapter 13 so the classification goes to the issue of payment rather than acceptance of the plan.

Since Bankruptcy Code Section 1327 vests property in the debtor upon plan confirmation, the treatment of secured creditors in Chapter 13 cases is a source of some difficulty. Bankruptcy Code Section 1325(a)(5) provides for three basic choices. The holder of a secured claim may accept the plan.102 Or the debtor may surrender the property to the secured claimant.103 The most likely event is that the debtor will seek to cram down the plan upon a secured creditor who has rejected the proposal.104 In order to effect a Chapter 13 cram down, the plan must provide that the lien will be retained by the holder of the secured claim and the value of the collateral will be paid pursuant to the plan.

A special secured claim is the long term debt. The normal period for a Chapter 13 plan is three years, but the court may permit a plan for as long as five years.105 Since a debt which will not be paid within the period of the plan cannot be discharged under Bankruptcy code Section 1328(a)(1), the long term debt is subject to special treatment provided by Section 1322(b)(2) and (5). Secured claims may be modified but not a debt secured by the debtor's principal residence.106 Since a house mortgage is typically both a secured claim and a long-term debt, special provision is made for cure of any pre-bankruptcy default and reinstatement of the regular payment terms.107

The most difficult issue in Chapter 13 is whether the plan may be confirmed if only nominal payment is offered to the unsecured creditors. Several factors are at work. One factor is the denial of any vote to unsecured creditors in the confirmation of the plan. Another factor is the super discharge available as an inducement to invoke Chapter 13 relief.108 The only exceptions to the super discharge of Chapter 13 are the long term debts and

family support obligations.109

Lawyers advising Chapter 13 debtors should advise clients to take into account the possibility of unanticipated events that may force the debtor in Chapter 13 to seek subsequent relief through liquidating bankruptcy in Chapter 7. A discharge in Chapter 7 may not be available more than once in seven years. A special provision applies to the Chapter 13 debtor in Bankruptcy Code Section 727(a)(8). A hardship discharge may be granted in Chapter 7 before six years elapse if the court in the Chapter 7 case makes a determination that special hardship should apply to the debtor. Request for the special hardship relief cannot be sought unless the prior Chapter 13 plan distributed at least 70 percent to the unsecured creditors.

Discharge

The completion of a confirmed Chapter 13 plan awards a "super discharge" of all but two debts.110 They are: (1) long term debt that exceeds the normal three-year limit for completion of the plan and (2) family support claim covered by Bankruptcy code Section 523(a)(5). Tax claims which are excepted by Bankruptcy Code Section 523(a)(1) are not avoidable through Chapter 13. The mandatory provision of the Chapter 13 plan requires full payment of priority claims unless the claimant agrees to accept less.111

If the debtor does not complete the plan as originally confirmed or subsequently modified, a second discharge option is provided for hardship.112 The hardship discharge is available only if the court determines the debtor's failure arose out of circumstances for which the debtor should not be justly accountable, that the value that was distributed in the aborted plan is not less than would have been available had liquidation through Chapter 7 occurred, and finally that modification of the Chapter 13 plan is not practicable. Where the hardship discharge is used, however, the full list of exceptions to discharge in Bankruptcy Code Section 523 apply.113 The exceptions to discharge were listed in the overview in this section on bankruptcy.

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1. Bankruptcy Code Section 302.

2. Bankruptcy Code Section 522(b)(2)(A).

3. Bankruptcy Code Sections 706, 1112, 1208, and 1307.

4. Bankruptcy Code Section 109.

5. Bankruptcy Code Section 301.

6. Bankruptcy Code Section 303.

7. Bankruptcy Code Section 303(b).

8. Bankruptcy Code Section 303(h).

9. Bankruptcy Code Section 303(a).

10. Bankruptcy Code Section 101(17).

11. Bankruptcy Code Section 101(33).

12. Bankruptcy Code Section 101(18).

13. Bankruptcy Code Sections 521(1) and 521(2)(A).

14. Bankruptcy Code Section 521(3).

15. Bankruptcy Code Sections 521(5) and 524(d).

16. Bankruptcy Code Section 362(a).

17. Bankruptcy Code Section 362(b).

18. Bankruptcy Code Section 362(c).

19. Bankruptcy Code Section 501(c).

20. Bankruptcy Code Section 501(b).

21. Bankruptcy Code Section 507(a).

22. Bankruptcy Code Section 544.

23. Bankruptcy Code Section 545.

24. Bankruptcy Code Sections 547(3) and 547(4).

25. Bankruptcy Code Section 101(29).

26. Bankruptcy Code Section 546(a).

27. Bankruptcy Code Section 546(b).

28. Bankruptcy Code Section 546(c).

29. Bankruptcy Code Section 546(d).

30. Bankruptcy Code Section 541(a).

31. Bankruptcy Code Section 541(a)(5)(A)-(C).

32. Bankruptcy Code Section 541(a)(6).

33. Bankruptcy Code Section 363(c)(1).

34. Bankruptcy Code Section 363(b)(1).

35. Bankruptcy Code Sections 361, 363(c)(2) and (3).

36. Bankruptcy Code Section 541(a)(1).

37. Bankruptcy Code Sections 503(b)(1)(A) and 507(a)(1).

38. O.R.C. 2329.66 and Bankruptcy Code Section 522(b)(1).

39. If there is a consenual lien on these assets and the net after debt value is less than the exemption, the exemption is reduced even to zero. On many farms the residence is a part of the farm real estate mortgage and there is no net value in the residence.

40. Bankruptcy Code Section 522(e).

41. Bankruptcy Code Section 522(b).

42. Bankruptcy Code Section 524(a).

43. Bankruptcy Code Section 523.

44. Cohen, Arnold B. and Mitchell W. Miller, CONSUMER BANKRUPTCY MANUAL, (New York: Warren, Gorham, & Lamont, 1985).

45. Bankruptcy Code Section 701(a).

46. Bankruptcy Code Section 701(b).

47. Bankruptcy Code Section 704.

48. Bankruptcy Code Section 702(d).

49. Bankruptcy Code Section 705.

50. Bankruptcy Code Section 706(a).

51. Bankruptcy Code Section 706(c).

52. Bankruptcy Code Section 721.

53. Bankruptcy Code Section 722.

54. Bankruptcy Code Section 1103(c).

55. Bankruptcy Code Section 1102 (b).

56. Bankruptcy Code Section 1104(a)(1).

57. Bankruptcy Code Section 1112(c); In re Jasik, 727 F.2d 1379 (5th Cir. 1984); In re Button Hook Cattle Co., 747 F.2d 483 (8th Cir. 1984).

58. Bankruptcy Code Section 1122.

59. Bankruptcy Code Section 1123(a).

60. Bankruptcy Code Section 1129(2)(A).

61. Bankruptcy Code Section 1127(a).

62. Bankruptcy Code Section 1127(b).

63. Bankruptcy Code Sectons 503(b)(1)(A) and 507(a)(1).

64. In re Garland Corp.. 6 Bankr. 456 (B.A.P. 1st Cir. 1980).

65. Bankruptcy Code Section 1126.

66. Bankruptcy Code Section 1141(a).

67. Bankruptcy Code Section 1142(a).

68. Bankruptcy Code Section 1141(d)(1)(A).

69. Bankruptcy Code Section 1141(d)(2).

70. Bankruptcy Code Section 101(17).

71. Bankruptcy Code Section 1201.

72. Bankruptcy Code Section 1202.

73. Bankruptcy Code Section 1203.

74. Bankruptcy Code Section 1204.

75. Bankruptcy Code Section 1205.

76. Bankruptcy Code Section 1206.

77. Bankruptcy Code Section 1207.

78. Bankruptcy Code Section 1208.

79. Bankruptcy Code Section 1221.

80. Bankruptcy Code Section 1222.

81. Bankruptcy Code Section 1223.

82. Bankruptcy Code Section 1224.

83. Bankruptcy Code Section 1225.

84. Bankruptcy Code Section 1226.

85. Bankruptcy Code Section 1227.

86. Bankruptcy Code Section 1228.

87. Bankruptcy Code Section 1229.

88. Bankruptcy Code Section 1230.

89. Bankruptcy Code Section 1231.

90. Bankruptcy Code Section 256.

91. Aaron, Richard I., BANKRUPTCY LAW FUNDAMENTALS (New York: Clark Bordman Company, Ltd., 1986).

92. Bankruptcy Code Section 109(e).

93. Bankruptcy Code Section 109(e).

94. Bankruptcy Code Section 1306(a).

95. Bankruptcy Code Section 1306(b).

96. Bankruptcy Code Section 1302.

97. Bankruptcy Code Section 1302(b)(1).

98. Bankruptcy Code Section 1302(c).

99. Bankruptcy Code Sections 1305(a) and 1328(d).

100. Bankruptcy Code Section 1302(2).

101. Bankruptcy Code Section 1301(a).

102. Bankruptcy Code Section 1325(a)(5)(A).

103. Bankruptcy Code Section 1325(a)(5)(C).

104. Bankruptcy Code Section 1325(a)(5)(B).

105. Bankruptcy Code Section 1322(c).

106. Bankruptcy Code Section 1322(b)(2).

107. Bankruptcy Code Section 1322(b)(5).

108. Bankruptcy Code Section 1328(a).

109. Bankruptcy Code Section 1328(a).

110. Bankruptcy Code Section 1328(a).

111. Bankruptcy Code Section 1322(a)(2).

112. Bankruptcy Code Section 1328(b).

113. Bankruptcy Code Section 1328(c).

TAX CONSEQUENCES OF LIQUIDATING FARM ASSETS

One of the major concerns which needs to be considered as assets are liquidated is tax. There are tax concerns when assets are liquidated, whether or not one is in bankruptcy.

A review of a check list is recommended whenever assets are to be liquidated. Some of the items on the check list are easily understood and do not take much explanation while others are less frequently encountered and require considerable study. Liquidation includes sale or transfer of an asset to a creditor.

The focus of this section is on debtors. Creditors also need to evaluate the tax impact of canceling debt and taking assets in lieu of foreclosure. These tax concerns are not presented in this material.

ORDINARY INCOME

One concern is that in a year of liquidation ordinary income will be experienced and that there will be few offsetting expenses. For example crops, livestock or other items could be sold early in the year, then the business liquidated later in the same year. The business would then have greatly reduced fertilizer, feed, chemical, seed and other expenses as production is phased out. This could also happen if bankruptcy is filed after experiencing income. When an individual files a Chapter 7 or 11 a new tax entity is created. As a result income generated by an individual before filing would not have offsetting expenses incurred after filing.

CAPITAL GAINS AND LOSSES

If capital assets, like land or raised breeding livestock, are being sold, capital gain may be encountered. Remember, in 1987 and thereafter this concern is magnified. Since the 60 percent deduction on capital asset sales does not apply after 1986.

It is also possible to have a loss when capital assets are liquidated. If land purchased after the mid-seventies is being liquidated a loss will likely be the result. Considerations, if they can be managed, are whether you want such a loss to occur inside or outside of bankruptcy or in which year it should occur?

RECAPTURE OF DEPRECIATION OR DEDUCTIONS ON OTHER SPECIAL EXPENSED ITEMS

When items like farm machinery or most real estate improvements are liquidated a recapture of depreciation is likely.1 For example: a tractor purchased for $30,000 and depreciated down to a current basis of $5,000 and sold for $10,000 results in a recapture of $5,000. This recapture is taxed at ordinary rates. A recapture can also occur if soil conservation expenses or land clearing expenses were taken as a deduction in the year the

work was done and the land upon which the work was done is being sold2. This recapture applies to land owned less than 10 years.

INVESTMENT TAX CREDIT RECAPTURE

Even though investment tax credit is no longer available for most assets acquired after January 1, 1986 several assets on the farm could still be within the recapture period. An item purchased in 1984 for $10,000 on which $1,000 of credit was taken would have a recapture of $600 if liquidated in 1987.3

ALTERNATIVE MINIMUM TAX

The alternative minimum tax is triggered if too much preferential income is experienced.4 The source of preferential income which was of greatest concern through 1986 as assets were liquidated was the 60 percent capital gain deduction. One example is: A farm with a basis of $80,000 and a fair market value of $200,000 resulted in an ordinary income tax of $9,000 but an alternative minimum tax of $16,000. The tax law says to pay whichever is higher. Remember a transfer of the farm to a creditor is treated as a sale and the tax result is the same. The alternative minimum tax continues after 1986 but there is no capital gain exclusion, therefore liquidating capital assets after 1986 will not trigger this tax.

There was a law passed on April 7, 1986 which gave an alternative minimum tax break for insolvent farmers.5 The tax break applies if land is transferred to a creditor or sold under a threat of foreclosure. The tax break applies to the extent of the insolvency. This law was retroactive to sales or exchanges of land after December 31, 1981. If an insolvent farmer encountered the alternative minimum tax from the sale of land anytime after January 1, 1982, an amended tax return should be filed. The 3 year time limit for filing amended returns continues to be applied under this tax law. The alternative minimum tax break only relates to land sales. Major sales of raised breeding livestock often triggered the alternative minimum tax but the exemption does not extend to these sales.

DISCHARGE OF INDEBTEDNESS INCOME

If it is possible to negotiate with a creditor to write down a loan or to transfer an asset to a creditor with the loan being satisfied when the asset is worth less than the balance due a discharge of indebtedness income is experienced. In the case of the transfer of an asset to a creditor and a debt discharge, assume a basis of $50,000, a current fair market value of $100,000 and a debt outstanding of $125,000. The difference between $50,000 and $100,000 is gain and will be reported as such. The difference between $100,000 and $125,000 is discharge of indebtedness income.6

The discharge of indebtedness in the above example relates to recourse, not nonrecourse debt. Most farm debt is recourse debt. For nonrecourse debt the difference between the basis, $50,000 and the outstanding debt of $125,000, would all be gain.7 As a result, discharge of indebtedness income never becomes a question with nonrecourse debt. However, under recourse debt with a discharge of indebtedness there is a more favored tax treatment.

The question is how to treat the $25,000 of discharged debt for recourse debt. The general rule is that debt discharge results in income. There are major exceptions to that rule which apply to most farm liquidations. The exceptions are, or in other words discharge of indebtedness is not income, when the taxpayer is in bankruptcy, is insolvent, or is in the trade or business of farming.8

However, there is a tax impact from discharged debt. The amount discharged offsets tax attributes. Tax attributes include net operating losses, tax credit carryovers, capital losses, basis of depreciable assets, basis in inventory, and a provision in the 1986 tax reform for solvent farmers even allows for a reduction of basis in land.9 After the tax attributes are used for farmers any additional discharge is not income. But remember, in the future there may be no net operating loss carryover deduction, no investment tax credit carryover, no depreciation to take, and the land may have a zero basis. Therefore, the taxes for the next several years could be higher. Also, upon the sale of an asset with a basis reduction under this provision any gain to the extent of the reduction must be recognized as ordinary income.

Another exception, discharge of a debt is not income if the debt related to an expense which would be tax deductible and the deduction has not yet been taken. Examples of such debts are interest, feed, seed, and fertilizer.

FEDERAL ESTATE TAX USE VALUATION RECAPTURE

If an inherited farm, which had a reduced federal estate tax because it qualified for the federal use valuation, is being liquidated, there will be a recapture by IRS of the taxes which were saved.10 For estates using federal use valuation in 1977 through 1981 the recapture period is 15 years, starting in 1982 the recapture period was reduced to 10 years.

OHIO ESTATE TAX USE VALUATION

If an inherited farm which is being liquidated had a reduced Ohio estate tax because it qualified for the Ohio use valuation there may be a recapture of those taxes saved.11 The Ohio recapture period is four years.

ACCELERATION OF FEDERAL OR OHIO ESTATE TAX INSTALLMENT PAYMENTS

If the farm being liquidated was inherited and the estate taxes are being paid over 15 years there may be an acceleration of the unpaid portion of the taxes.12 If more than 50% of the farm assets in the estate are being transferred an acceleration will occur.

PURCHASE PRICE ADJUSTMENTS

Purchase price adjustments on seller financed property, if not in bankruptcy or insolvent, are treated favorably under the tax law.13 This type of negotiation is occurring and sellers and buyers need to be aware of the favorable tax results:

- no gain is reported by the seller on the amount of write down;
- buyer must reduce the basis of the purchased property;
- if the basis reduction in depreciable property goes below the current basis there could be a recapture of the depreciation already taken; and
- there could be an investment tax credit recapture for the buyer.

For related sellers and buyers there is a conflicting law which may not allow this favorable treatment. That conflicting law says when related sellers write down the purchase price the capital gain must be reported as if the dollars are received14.

ELECT SHORT TAX YEAR-BANKRUPTCY

When electing bankruptcy consider electing a short tax year as an individual. For an individual, not a partnership or corporation, filing a Chapter 7 or 11, a separate tax entity is created for the bankruptcy estate. If a short tax year election is made, the taxes of the individual, in theory, become due before the bankruptcy is filed. As a result the unpaid taxes of that short year become a preference item to be paid by the bankruptcy estate. However, if unpaid by the estate, those taxes will still be owed by the individual. In contrast, if the short tax year was not filed the individual would owe such taxes and the liability is not at all one for the bankruptcy estate.15

Filing of the short tax year also allows the tax attributes, net operating losses, investment tax credit carryovers, and depreciation, to be used by the individual first. The residual goes to the bankruptcy estate. If the election is not made the individual is not able to use any of these attributes.

The short tax year election must be filed within 4 1/2 months of the date of filing for bankruptcy.

TAX PLANNING STRATEGIES

Tax planning strategies as assets are liquidated:

- liquidate assets over 2 or more years;
- reduce other income in year of liquidation;

- for individuals, elect bankruptcy (with a Chapter 7 or 11, a new tax entity is created and taxes incurred while in bankruptcy are the estate's responsibility not the individual's);

- purposefully place taxable income into the bankruptcy estate rather than in the individuals taxable income;

- elect a short tax year in the year of filing bankruptcy;

- decide if the alternative minimum tax break for insolvent farmers can be used; and

- decide if a purchase price adjustment can be made between buyer and seller.

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CREDITOR LIABILITIES[1]

Often with the intent to be helpful some creditors may make suggestions and promises which increase their liability to their farm customers. Other creditors in order to counter the greater risk of financial loss and protect security interests often are inclined to be more aggressive and make suggestions, monitor the debtor's business and enforce collections.

The number of lawsuits brought by farmers as debtors against their creditors of recent times has increased. It has not been uncommon for courts to find that there is a fiduciary relationship between a creditor and a debtor when the creditor actively participates in the debtor's business decision making. Creditors have also been found liable if guilty of a breach of the loan agreements, if the creditor has committed an act which is not permitted by statutory or common law or if the creditor fails to complete tasks as required by law.

The increased potential for litigation has created a dilemma for creditors. The creditor has the right to protect a security interest as long as actions are in good faith and not beyond what a normal creditor would do. On the other hand, if the creditor becomes too involved in a client's business, that creditor may be liable to the debtor and in some cases may also be liable to other creditors of the debtor.

FIDUCIARY RELATIONSHIP

A fiduciary relationship arises whenever confidence is reposed on one side and domination and influence result on the other. Such a relationship exists when there is a reposing of faith, confidence, and trust, and the placing of reliance by one upon the judgment and advice of another.[2] If a fiduciary relationship can be established through court proceedings then the theory that the creditor needs to accept a part, if not all, of the risks of loss related to the loan in question is supported. This finding could stop the creditor from attempting to collect on the loan and could cause the creditor to be held responsible for other losses incurred by the debtor.

Normal debtor/creditor relationships are not considered to be fiduciary.[3] Normally, the debtor/creditor dealings are considered to be arms length relationships with each party bargaining in his own best interest. However, there are situations where the creditor dominates the debtor and at least some business decisions result from the creditor's influence and the debtor's reliance.

There is no one factor which determines creditor control.[4] Each case is determined by its specific facts and circumstances.[5] A court considers acts performed and decisions made by the creditor which were followed by the debtor; i.e., manage-

ment, hiring and firing, or other operational decisions.6 The court then weighs the evidence to determine whether control was exercised by the creditor.

The recent cases on this fiduciary liability have the following elements in common: an established debtor/creditor relationship, advice given by the creditor, reliance by the debtor, and a court recognized damage to the debtor.

CONTRACTUAL RELATIONSHIPS, WRITTEN CONTRACTS

Every contract has an implied covenant of good faith and fair dealing.7 This covenant enables each contracting party to rely on representations made by the other. The covenant implies that neither party will do anything which injures the right of the other to receive the benefits of the agreement.8

There have been cases where a creditor refused to follow contract terms even when the creditor's position was fully protected.9 In the cited case the creditor was found to be liable to the debtor. A creditor is acting in good faith and fair dealing as long as the creditor discloses any information required to protect the debtor's benefits of the loan agreement.10 The creditor has no duty to disclose management information it may have relative to the debtor's proposed investment. The bank is under no duty to offer investment advice as to the probabilities for success.11

CONTRACTUAL RELATIONSHIPS, ORAL COMMITMENTS

Creditors who discuss potential loans with prospective borrowers in terms that do not clearly indicate no commitment to actually loan, may run the risk of being liable, especially where the borrower has taken steps in reliance on discussions.

Further, debtors and creditors who through prior dealings have developed ways of doing business may give a court evidence to find a contracted loan that was not intended by the creditor.12 In the above footnoted case, the court determined that a breach of contract action required the following: (1) the alleged existence of a contract that was breached which includes offer, acceptance, and consideration on the part of both parties; (2) the alleged agreement must be complete and definite as to its terms to a reasonable certainty; (3) must show the debtor performed all conditions required to make the contract binding; (4) must show how the contract was breached; and (5) must show damages as a consequence of the breach.13 In that case the court found an oral contract did exist between the farmer and the lender and that the contract had been breached by the lender. The farmer, borrower, in that case had met all the terms that were discussed orally and the court found that the farmer's reliance constituted a contract causing the bank to be liable on the oral agreement.

STATUTORY LIABILITY, COMMERCIAL REASONABLENESS

Creditors may be found liable if they do not follow statutory requirements. One example would be that the UCC has a statute saying the lender when repossessing property and selling said property must perform all functions with a commercial reasonableness.

In determining commercial reasonableness, the court considers many factors which include the nature of the collateral, resale price, the nature and amount of advertising, the efforts to meet the appropriate market, the methods used to solicit bidders or purchasers, the number of buyers contacted before the sale, whether the sale was public or private, the number of bids received, the presence of self dealing, and the good faith of the secured party.14

The U.C.C. Chapter 9, codified into O.R.C. Chapter 1309, sets forth many statutory standards for creditors as well as debtors. Creditors and debtors may find their rights and responsibilities altered if these code sections are not followed.

STATUTORY LIABILITY, CREDITOR NOTICE TO COMAKER

Comakers on a note are entitled to the same type of notices which are sent to the principal party on the note. In an Ohio case the creditor did not supply this notice to the comakers on a promissory note as required by statute. The court held the creditor could not collect a deficiency from the comakers after the sale of collateral.15

COMMON LAW, NEGLIGENCE

A debtor may be able to recover under tort law against a creditor for activity which damages the debtor but does not constitute a breach of contract. Actions could be brought under a theory of negligence. In such case the debtor must show evidence that the elements of negligence were present. The three elements common to all negligence cases are: (a) a duty owed (creditor owes a duty to debtor), (b) breach of the duty owed, and (c) damages proximately caused by that breach.

Normally the creditor in a debtor/creditor relationship would not have an actionable duty to the debtor. Where the relationship between the creditor and debtor has developed into a fiduciary one, there would be a duty.16 If this has occured the creditor needs to be sure its' actions, recommendations, and decisions do not reach a level of negligence.

COMMON LAW, ECONOMIC DURESS/COERCION

Duress exists where there is a threat to do an act which a party has no legal right to request, thereby forcing the other party to act against his/her free will and do something which he/she is not legally bound to do.17 The other party acts through fear of injury to business or other interests. If a debtor's finances have deteriorated to the point that financing can

not be obtained elsewhere the creditor has the leverage to force the debtor's actions. If the creditor in that circumstance makes requests of the debtor of which he has no legal right to do a debtor may have a right of action.

FRAUD

A creditor may be liable for fraud if false statements or information are used to gain control of the debtor's business or force management decisions.

CREDITOR INTERFERENCE

The creditor may be held liable if the creditor makes the debtor breach contracts with others. Elements which would have to be proven by the debtor in such case are: (1) the existence of a valid contract, (2) the creditor's knowledge of the contract, (3) an intent to interfere, and (4) damage to the debtor's business.18

JOINT VENTURE

A creditor may be held to the same liabilities as the debtor if the debtor and creditor share a joint interest in a mutual business undertaking. This concept follows the joint and several liability characteristic common to partnerships.

SUGGESTIONS FOR CREDITORS19

The recommendations to creditors are: (1) do not hesitate to make inspections, ask questions, etc. to exercise prudent lending practices; (2) do not dominate a debtor's decision making; (3) make sure loan documents clearly spell out the rights and responsibilities of both parties and then follow the agreements; (4) be certain that all involvement in the debtor's business is primarily to protect the security interest of the creditor; (5) make sure that if the creditor suggests business decisions to be made by the debtor, that alternatives are discussed and the final decisions are made by the debtor; (6) maintain a file of important topics discussed with debtors; (7) be cautious when using clauses and agreements which create debtor concepts of lender leverage, i.e., "payable upon demand" or "deem oneself unsecured"; (8) do not maintain a file of statements made by one employee in cricitism of another concerning management of a loan; (9) develop a policy manual for dealing with debtors which recognizes liability concerns; (10) conduct educational meetings for employees on the topic of lender liability; (11) have only one employee relate with a customer on all business relationships between the parties to facilitate bank understanding and reduce the risk of conflicting statements; (12) stand behind bank employee commitments to customers; (13) be sure the employee performance evaluation relates to many factors in addition to loan volume; (14) never base pay increases on loan volume and (15) use facts from current court cases as references for educational seminars and policy development.

SUGGESTIONS FOR DEBTORS

As business dealings are

conducted with creditors, debtors should be sure those dealings are at arms length. Recommendations for debtors include: (1) document discussions with creditors; (2) have ambiguous terms of contracts explained before signing; (3) have the terms of agreements relative to what the creditor will and will not allow clearly defined; (4) have an attorney review loan documents before signing if a creditor is in a superior bargaining position; (5) be aware of the fact that a creditor is dealing in his/her own best interest and may not be volunteering information relevant to the debtor's business; and (6) be cognizant that the debtor is responsible for his/her own loan decisions.

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SUMMARY OF DEBTOR/CREDITOR LAW

The relationship between debtors and creditors is goverened by agreements, statutes and common law. Usually the terms of the contracts are met without conflict. Financial stress calls to attention the terms of agreements and the finites of the law.

It is recommended that both debtors and creditors attempt to understand and follow the terms of all agreements between them. If the terms of agreements can not be met the first step is communication between the parties.

If cosigners become involved in loan agreements it is essential that they understand their obligations. Questions should be asked about the responsibilities and the consequences of default by the debtor.

Tax concerns exist within most business transactions. They are no less of a concern when assets are being liquidated under financial stress. The tax concerns need to be analyzed before business decisions become irrevocable.

Creditors have rights of collection once default has occured. Those rights need to be understood by debtors experiencing payment problems.

There are numerous responses to financial difficulties which debtors should review. Coping with financial problems deserves careful attention.

One possible debtor response is to elect bankruptcy. This possibility ought to be elected only after other alternatives are thoroughly explored and exhausted. There are four types of bankruptcy available to farmers: Chapters 7, 11, 12 and 13. If bankruptcy is the choice most farmers will elect either a chapter 7 or 12. Once bankruptcy is elected the debtor and creditor are under the jurisdiction of the Federal Bankruptcy Court.

Competent advice and counsel should be found as financial difficulties are encountered. Attorneys, accountants, and farm management counselors can provide the needed assistance.